Keep to the Straight and Narrow: Walking the Ethical Path Through Bankruptcy

April 5, 2003
California State Bar Convention, Business Law Section,
Spring 2003
Los Angeles, California

Panelists:

The Honorable Samuel Bufford, Bankruptcy Judge for the Central District of California

Professor John D. Ayer, UC Davis School of Law

Adam Lewis, Morrison & Foerster, San Francisco

1. Ethical issues in pre-bankruptcy planning - a historical perspective and analysis of the law as it currently stands. (Professor Ayer)	
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In re: STEVEN H. STERN, Debtor, DAVID A. GILL, Chapter 7 Trustee, Appellant, v. STEVEN H. STERN, Appellee. In re: STEVEN H. STERN, Debtor, STEVEN H. STERN, Appellant, v. DAVID A. GILL, Chapter 7 Trustee, Appellee. and DOVE AUDIO, INC., Plaintiff.

No. 00-56431, No. 00-56526

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

317 F.3d 1111; 2003 U.S. App. LEXIS 1828; Bankr. L. Rep. (CCH) P78,793; 2003 Cal. Daily Op. Service 1093; 2003 Daily Journal DAR 1377

June 5, 2002, Argued and Submitted, Pasadena, California

February 4, 2003, Filed

SUBSEQUENT HISTORY:

As Corrected February 27, 2003.

PRIOR HISTORY:

[*1] Appeal from the United States District Court for the Central District of California. D.C. No. CV-98-07415-GAF. Gary A. Feess, District Judge, Presiding.

DISPOSITION:

Affirmed.

CASE SUMMARY

PROCEDURAL POSTURE: Appellant bankruptcy trustee appealed an order of the United States District Court for the Central District of California, which affirmed an order of the bankruptcy court granting summary judgment in favor of appellee debtor. The debtor cross-appealed the district court's determination that his pension-plan funds were not excluded from the bankruptcy estate.

OVERVIEW: At issue was whether a transfer of proceeds from an individual retirement account into a profit-sharing pension plan was a fraudulent conveyance, subject to avoidance by the trustee. As of the date of the bankruptcy filing, the debtor was married to the only other beneficiary of the pension plan. Before the marriage, the spouse was the sole employee of the pension plan. At the time of the filing, the plan covered an owner and a spouse of an owner, neither of which met the definition of employee. Thus, the pension plan was not ERISA-qualified at the time of the filing, and the assets of the pension plan were not exempt from the bankruptcy estate by virtue of ERISA qualification.

However, the assets were exempt under Cal. Civ. Code § 704.115(b), as the trustee did not challenge applicability of that statute, unless the transfer into the pension plan was fraudulent. The transfer was not fraudulent. The inference that non-exempt assets were converted to exempt assets immediately prior to bankruptcy was insufficient as a matter of law to establish a fraudulent conveyance. Other badges of fraud were not supported by sufficient evidence to create a genuine issue of material fact.

OUTCOME: The district courts decisions were affirmed.

LexisNexis(TM) HEADNOTES - Core Concepts

Bankruptcy Law > Practice & Proceedings > Appeals [HN1] The court of appeals reviews the bankruptcy court's grant of summary judgment de novo. The court must determine whether, viewing the evidence in the light most favorable to the non-moving party, genuine issues of fact remain for trial. The court also must determine whether the bankruptcy court correctly applied the

relevant substantive law.

Bankruptcy Law > Practice & Proceedings > Appeals [HN2] The court of appeals reviews the district court's decision on appeal from the bankruptcy court de novo, without giving deference to the district court's conclusions.

Bankruptcy Law > Exemptions > Bankruptcy Code Exemptions

[HN3] If a pension plan is ERISA-qualified, the assets in the plan are thereby excluded from a bankruptcy estate.

The status of the pension plan is determined as of the date of the bankruptcy filing.

Bankruptcy Law > Exemptions > Bankruptcy Code Exemptions

[HN4] Absent at least one employee beneficiary, a pension plan is not ERISA-qualified for purposes of exemption from a bankruptcy estate.

Pensions & Benefits Law > Employee Retirement Income Security Act (ERISA) > Exempt Plans

[HN5] 29 U.S.C.S. § 1002(1) defines an ERISA-qualified welfare benefit plan as one established or maintained for the purpose of providing benefits for its participants on their beneficiaries. 29 U.S.C.S. § 1002(1). In contrast, a pension plan is ERISA-qualified only to the extent that by its express terms or as a result of surrounding circumstances the pension plan provides retirement income to employees. 29 U.S.C.S. § 1002(2)(A)(i).

Bankruptcy Law > Exemptions > Bankruptcy Code Exemptions

[HN6] For purposes of exemption from a bankruptcy estate, ERISA qualification for a welfare benefit plan is determined after considering the purpose of the plan when it was established or as it is maintained. The court assesses ERISA qualification for a pension plan by gauging whether there is at least one extant employee beneficiary. The assessment is made as of the bankruptcy filing date.

Bankruptcy Law > Exemptions > Individual State Exemptions

[HN7] See Cal. Civ. Code § 704.115(b).

Bankruptcy Law > Exemptions > Bankruptcy Code Exemptions

[HN8] The purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se.

Bankruptcy Law > Examiners & Trustees > Fraudulent Transfers

[HN9] In the context of an alleged fraudulent transfer, a finding of fraud must be established by clear and convincing evidence.

Bankruptcy Law > Exemptions > Bankruptcy Code Exemptions

[HN10] The exemption determination is to be determined upon the basis of conditions existing at the time of the filing of the bankruptcy petition.

COUNSEL:

Richard D. Burstein, Danning, Gill, Diamond & Kollitz, Los Angeles, California, for the appellant.

David R. Weinstein (argued), Sharon Z. Weiss (briefed), Weinstein, Eisen & Weiss, Los Angeles, California, for the appellees.

JUDGES:

Before: Arthur L. Alarcon, Barry G. Silverman and Johnnie B. Rawlinson, Circuit Judges. Opinion by Judge Rawlinson; Partial Concurrence and Partial Dissent by Judge Alarcon.

OPINIONBY:

Johnnie B. Rawlinson

OPINION:

RAWLINSON, Circuit Judge:

David A. Gill, Bankruptcy Trustee ("Trustee"), appeals the district court's decision affirming the bankruptcy court's order, which granted summary judgment in favor of the debtor Steven Stern ("Stern"). Stern cross-appeals the district court's determination that Stern's pension plan funds are not excluded from the bankruptcy estate.

Stern filed for bankruptcy after the entry of a sizeable judgment against him in an arbitration proceeding. We must determine whether the transfer of proceeds from an [*2] Individual Retirement Account ("IRA") into a Profit Sharing Pension Plan was a fraudulent conveyance, subject to avoidance by the Trustee. n1

n1 The remaining creditors did not actively participate in the appeal.

Constrained by our precedent, we AFFIRM the district court's holding that, although the pension plan was properly included within the bankruptcy estate, the pension plan assets were exempt from distribution to Stern's creditors.

I.

Background

Stern's retirement planning commenced with the creation of a tax-qualified profit-sharing plan in 1974 ("1974 Plan"). n2 In 1978, Stern terminated the 1974

Plan and created a qualified, defined benefit pension plan ("1978 Plan"). In 1989, Stern terminated the 1978 Plan and transferred the plan assets into an IRA account ("IRA").

n2 The retirement plans were established under the auspices of Steven H. Stern, Inc., and benefitted Stern and his then-wife Sharma, who were both employees of Stern, Inc.

[*3]

Stern became embroiled in a business dispute with Dove Audio, Inc. in 1991. The dispute culminated in an arbitration award of over \$ 4.5 million dollars against Stern. At about the same time, Stern hired Margaret Mayersohn ("Mayersohn"), with whom he became romantically involved, and later married.

In April 1992, Stern created a Profit Sharing Plan ("1992 Pension Plan") with Mayersohn and Stern as beneficiaries. On October 22, 1992, the Los Angeles Superior Court issued a writ of attachment to secure the arbitration award. The next day, Stern executed the Plan Documents for the 1992 Pension Plan and, a few days later, transferred the proceeds of his IRA into the 1992 Pension Plan. Dove filed a fraudulent conveyance action in state court, contending that Stern's transfer of funds from his IRA into the 1992 Pension Plan was a fraudulent transfer designed to shield his assets from creditors. Stern, in turn, initiated a voluntary Chapter 7 bankruptcy proceeding. The creditors removed the fraudulent conveyance action to the bankruptcy court as an adversary proceeding.

Stern filed a Motion for Summary Judgment in the core bankruptcy proceeding, seeking to exclude the assets of the 1992 [*4] Pension Plan from the bankruptcy estate. Stern also sought summary judgment on the fraudulent transfer claim in the adversary proceeding.

The bankruptcy court ruled that the 1992 Pension Plan was excluded from the bankruptcy estate because it was a qualified plan under the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). The bankruptcy court also concluded that, although the 1992 Pension Plan assets were not excluded from the estate under California law, the 1992 Pension Plan's assets were exempted from creditors' claims under California law. Finally, the bankruptcy court held that Stern's transfer of assets from the IRA to the exempt 1992 Pension Plan was not a fraudulent transfer. The

creditors appealed the bankruptcy court's rulings to the district court.

The district court rendered the following rulings on appeal:

- 1. The 1992 Pension Plan was not ERISA qualified;
- 2. The 1992 Pension Plan was not excludable under state law;
- 3. The 1992 Pension Plan was exempt under California law; and
- 4. The transfer of assets from Stern's IRA to the 1992 Pension Plan was not a fraudulent conveyance.

Stern appeals the district court's [*5] ruling that the 1992 Pension Plan was not ERISA-qualified. The Trustee appeals the district court's rulings that the 1992 Pension Plan was exempt under California law, and that the transfer of assets from the IRA to the 1992 Pension Plan was not a fraudulent transfer.

П.

Standard of Review

[HN1] We review the bankruptcy court's grant of summary judgment de novo. Clicks Billiards, Inc. v. Sixshooters, Inc., 251 F.3d 1252, 1257 (9th Cir. 2001). We must determine whether, viewing the evidence in the light most favorable to the non-moving party, genuine issues of fact remain for trial. Oliver v. Keller, 289 F.3d 623, 626 (9th Cir. 2002). We also must determine whether the bankruptcy court correctly applied the relevant substantive law. Id.

[HN2] "We review the district court's decision on appeal from the bankruptcy court *de novo*, without giving deference to the district court's conclusions." *In re Harmon*, 250 F.3d 1240, 1245 (9th Cir. 2001) (citation omitted). Because the facts in this case are virtually undisputed, we focus on the court's application of law to the facts. n3

n3 The Trustee objected to consideration of certain affidavits submitted by Stern in support of his summary motion. However, the affidavits were in compliance with the requirements of Rule 56(e) of the Federal Rules of Civil Procedure. Block v. City of Los Angeles, 253 F.3d 410, 419 (9th Cir. 2001) (stating that affidavits must be based upon personal knowledge and contain

admissible evidence). Contrary to the Trustee's assertion, the affidavits were not so inconsistent with deposition testimony that the bankruptcy court abused its discretion in considering the affidavits.

[*6]

III.

Discussion

A. ERISA-Qualified Status of the 1992 Pension Plan

If the 1992 Pension Plan was [HN3] ERISA-qualified, the assets in the plan were thereby excluded from the bankruptcy estate. See Patterson v. Shumate, 504 U.S. 753, 757-58, 119 L. Ed. 2d 519, 112 S. Ct. 2242 (1992); In re Conner, 73 F.3d 258, 259-60 (9th Cir. 1996). The status of the pension plan is determined as of the date of the bankruptcy filing. Lowenschuss v. Selnick (In re Lowenschuss), 171 F.3d 673, 680 (9th Cir. 1999).

It is undisputed that, as of the date of his bankruptcy filing, Stern was married to Mayersohn, the only other beneficiary of the 1992 Pension Plan. Prior to the marriage, Mayersohn was the sole employee of the 1992 Pension Plan. n4 [HN4] Absent at least one employee beneficiary, a pension plan is not ERISA-qualified. See Peterson v. American Life & Health Ins. Co., 48 F.3d 404, 407-08.

n4 Stern, as sole owner of the 1992 Pension Plan's sponsor, did not fit within the definition of employee. See Peterson v. American Life & Health Ins., 48 F.3d 404, 408 (9th Cir. 1995).

[*7]

Although Stern acknowledged the applicability generally of *Lowenschuss*, he challenges its applicability specifically to the facts of this case. Relying upon *Peterson*, Stern contended that his marriage to Mayersohn did not alter the ERISA-qualified status of the 1992 Pension Plan.

We agree with the district court that the fact that *Peterson* concerned an employee welfare benefit plan and *Lowenschuss* addressed a pension plan is outcome determinative.

29 U.S.C. § 1002(1) [HN5] defines an ERISA-qualified welfare benefit plan as one "established or maintained ... for the purpose of providing [benefits] for its participants on their beneficiaries[.]" 29 U.S.C. §

1002(1) (West 1999). In contrast, a pension plan is ERISA-qualified only "to the extent that by its express terms or as a result of surrounding circumstances [the pension plan] provides retirement income to employees ..." 29 U.S.C. § 1002(2)(A)(i) (West 1999).

Taking into account the welfare benefit plan definition's focus on the past and the pension plan definition's emphasis on the present, *Peterson* and *Lowenschuss* are easily [*8] reconciled. Under the rationale of *Peterson*, [HN6] ERISA qualification for a welfare benefit plan is determined after considering the purpose of the plan when it was established or as it is maintained. In *Lowenschuss*, however, we are instructed to assess ERISA qualification for a pension plan by gauging whether there is at least one extant employee beneficiary. Under *Lowenschuss*, the assessment is made as of the bankruptcy filing date.

There is no dispute that as of the bankruptcy filing date, the 1992 Pension Plan covered an owner and the spouse of an owner, neither of which met the definition of employee. See Peterson, 48 F.3d at 408; see also 29 C.F.R. § 2510.3-3(c)(1).

The district court properly applied *Lowenschuss* and determined that the 1992 Pension Plan was not ERISA-qualified at the time of the bankruptcy filing. As a result, the assets of the 1992 Pension Plan were not exempt from the bankruptcy estate by virtue of ERISA qualification.

B. Exemption of the 1992 Pension Plan Under California Law n5

n5 11 U.S.C. § 522(b) permits the debtor to claim exemptions under state law.

[*9]

Cal. Civ. Proc. Code § 704.115(b) provides: [HN7] "All amounts held, controlled, or in process of distribution by a private retirement plan, for the payment of benefits as an annuity, pension, retirement allowance, disability payment, or death benefit from a private retirement plan are exempt."

The Trustee does not take issue per se with the applicability of Cal. Civ. Proc. Code § 704.115(b). Rather, the Trustee challenges the exemption on the basis that Stern's transfer of assets from the IRA into the 1992 Pension Plan was a fraudulent conveyance. That brings us to the final issue before us.

C. Transfer of Assets Into the 1992 Pension Plan

The Trustee vigorously advocates that Stern's transfer of assets from his IRA into the 1992 Pension Plan was fraudulent, and therefore, the assets are not exempt from the reach of creditors.

We are controlled by our prior opinion in Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971). In that case, we ruled "that [HN8] the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se." Id. at 989 (citation omitted).

The facts of Wudrick are not unlike our case. [*10]

When bankruptcy appeared inevitable, Mr. and Mrs. Roon consulted experienced bankruptcy counsel. One of the things they did on his advice to enhance their exemptions was to refinance their 1966 Chevrolet. The bank loaned them \$ 2,325 on the car. From this amount they paid off the previous car loan and their attorney's fees, and deposited \$ 800 in the Union Federal Savings & Loan Association. They then filed petitions in bankruptcy. They claimed that the \$ 800 account was exempt from execution under California [law] and was therefore exempt under section 6 of the Bankruptcy Act, 11 U.S.C. § 24, though the automobile would not have been.

Id.

In reversing the district court's determination that Wudrick engaged in a fraudulent conveyance, we clarified that "the finding of fraud was based solely on the fact that nonexempt assets were deliberately converted to exempt assets just prior to filing the bankruptcy petition." *Id. at 990.* We explained that this "evidence was insufficient as a matter of law to establish fraud." *Id.* Our analysis was impliedly affected by the clarification that a different conclusion might be reached [*11] "if on the eve of bankruptcy a debt were created with no intention of repaying the creditor" *Id.*

Here, the principal evidentiary inference relied upon by the Trustee is that non-exempt assets were converted to exempt assets immediately prior to bankruptcy. But, as Wudrick demonstrates, this inference is insufficient as a matter of law to establish a fraudulent conveyance. Moreover, when analyzed under the appropriate evidentiary standard of clear and convincing evidence, see Anderson v. Liberty Lobby, 477 U.S. 242, 254, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986) ("in ruling on a motion for summary judgment, the judge must view the evidence presented through the prism of the substantive evidentiary burden"), the remaining "badges of fraud" relied upon by the Trustee are not supported by sufficient

evidence to create a genuine issue of material fact that Stern's transfer of assets was a fraudulent conveyance.

The dissent seeks to distinguish Wudrick by citing to Love v. Menick, 341 F.2d 680 (9th Cir. 1965). However, Menick actually supports a finding of exemption. In Menick, we recognized that " the exemption statutes [*12] of California are applied with liberality." Id. at 682 (citations omitted). We also noted that [HN9] a finding of fraud must be established by "clear and convincing" evidence. Id. (citation omitted). Finally, we clarified that [HN10] the exemption determination is to be determined "upon the basis of conditions existing at the time of the filing of the bankruptcy petition." Id. (citations omitted). As in Menick, when Stern's bankruptcy petition was filed, the assets in question "rested in [the 1992 Pension Plan] which ... enjoyed an exempt status." Id.

The dissent also cites Acequia Inc. v. Clinton, (In re Acequia, Inc.), 34 F.3d 800 (9th Cir. 1994) in support of its position. However, that case is inapposite because the property transferred did not enjoy an exempt status when the bankruptcy petition was filed. The rationale of Wudrick is inapplicable to a situation such as that presented in Acequia, but completely pertinent to the case at hand, where assets are converted to an exempt status pre-bankruptcy. At bottom, the "badges of fraud" articulated in the dissent merely rephrase the argument that Stern transferred funds from his [*13] IRA account into the 1992 Pension Plan Account on the eve of bankruptcy. In such a circumstance, we are persuaded that Wudrick controls.

We recognize that the "badges of fraud" identified by Judge Alarcon in his thoughtful dissent offer some support for the conclusion that there is evidence in the record that could be construed as creating a genuine issue of material fact. However, under Anderson v. Liberty Lobby, Inc., 477 U.S. at 254-56 and its progeny, this elevated standard of clear and convincing proof must govern our evaluation of the evidence. Although a colorable argument could perhaps be made that there is some evidence of fraudulent conveyance, we simply believe, after reviewing the record de novo, that the existing evidence fails to create a genuine issue of material fact when evaluated under the elevated evidentiary standard governing fraudulent conveyance.

Accordingly, we AFFIRM the district court's rulings that the 1992 Pension Plan was not ERISA-qualified; that the 1992 Pension Plan was exempt under California law; and that the transfer of assets from Stern's IRA to the 1992 Pension Plan was not a fraudulent conveyance. **AFFIRMED**.

CONCURBY:

Arthur [*14] L. Alarcon (In Part)

DISSENT:

ALARCON, Senior Circuit Judge, Concurring in Part, Dissenting in Part:

I concur in the majority's holding that the funds in the Plan were not excludable from Stern's bankruptcy estate. I dissent from the majority's conclusion that the funds in the Plan were exempt from distribution to Stern's creditors under California law. I would hold that the Trustee presented sufficient facts to support an inference that Stern transferred funds into the Plan with the intent to hinder, delay, or defraud his creditors. A fraudulent transfer is not exempt from distribution to creditors under California law. Cal. Civ. Code § § 3439.04 & 3439.05 (West 2002); Maddox v. Robertson (In re Prejean), 994 F.2d 706, 708 (9th Cir. 1993). Accordingly, whether the Debtor acted with fraudulent intent is a question that should be determined after a trial on the merits and a determination of the credibility of the witnesses regarding Stern's intent.

The Trustee presented evidence that on September 15, 1992, Dove Audio, Inc. ("Dove") received an arbitration award of 4,585,000 dollars against Stern. Stern learned of the award on or about September 30, 1992. On October 22, 1992, the [*15] Los Angeles Superior Court issued a writ of mandate to secure the payment to Dove of the amount awarded by the arbitrator.

On October 14, 1992, Stern filed for a divorce. The next day, Stern received a Default Judgment of Dissolution of his marriage that included a stipulated property settlement agreement. Between October 19, 1992 and October 21, 1992, pursuant to the property settlement agreement, Stern transferred all his community property, consisting of over 2 million dollars in nonexempt assets, to Sharma Stern. Stern made these transfers without the benefit of property appraisals. Stern retained only supposedly exempt assets and assumed the 4.5 million dollar arbitration award, a community debt, owed to Dove. On October 23, 1992, Stern executed the documents that created the Plan. Later in the same month, Stern rolled 1.4 million dollars from his IRA into the Plan. On November 2, 1992, Stern filed for bankruptcy. Stern dismissed the Chapter 11 action on December 22, 1992, after the bankruptcy judge indicated that she would appoint a trustee for Stern's estate.

In July 1993, Dove filed an action in the Los Angeles Superior Court in which it alleged that Stern had fraudulently [*16] transferred the 1.4 million dollars into the Plan to shield his estate from his creditors. On August 11, 1995 while the fraudulent conveyance action was pending in state court, Stern filed a Chapter 7 bankruptcy petition (the "core proceeding"). In the fall of 1995, Dove transferred the fraudulent conveyance action (the "adversary proceeding") to the bankruptcy court. On June 26, 1996, the Trustee was authorized to intervene in the adversary proceeding.

On or about March 27, 1998, Stern filed a motion for summary judgment in the core proceeding. He sought to prevent the money in the Plan from being included in the bankruptcy estate. He argued that: (1) the Plan is excludable from the bankruptcy estate as ERISA-qualified; (2) the Plan is exempt from creditor distribution under California law; and (3) even if there had been a fraudulent transfer, the Plan would still be exempt. The Trustee responded on April 27, 1998. The bankruptcy court agreed with Stern's arguments. It held that the Plan was excluded from the estate as ERISA-qualified and that it was also exempt under California law.

On or about May 11, 1998, Stern moved for summary judgment on the fraudulent transfer claims in [*17] the adversary proceeding. Stern asserted that there was no transfer. He asserted in the alternative that even if there had been a transfer, the Trustee could not show that it was fraudulent. In response, the Trustee disputed Stern's legal arguments and asserted that there was a question of fact regarding Stern's credibility and his intent regarding the transfer. The bankruptcy court concluded that there was nothing improper about transferring assets into an exempt retirement fund on the eve of bankruptcy.

The Trustee timely appealed the bankruptcy court's rulings on summary judgment to the district court. On August 9, 2000, the district court concluded that the funds in the Plan were not excludable as ERISA-qualified. It also concluded that the funds were exempt from distribution to creditors under California law because the Trustee failed to present evidence of fraud beyond the mere transfer of funds on the eve of bankruptcy.

Under California law, funds held in a "private retirement plan" are exempt from distribution to creditors. Cheng v. Gill (In re Cheng), 943 F.2d 1114, 1116 (9th Cir. 1991); Cal. Civ. Proc. Code § 704.115(b)-(e) (West 2002). Corporate plans [*18] are entitled to complete exemption even where the corporation sponsoring the plan is closely held and its sole shareholder, director, and chief executive officer is the debtor. In re Cheng, 943 F.2d at 1115-17. The Plan

in the instant case is a corporate plan, sponsored by Stern, Inc., and is therefore exempt. Stern argues that even if we assume that he transferred the funds into the Plan to defraud his creditors, the funds nevertheless remain exempt as part of the corporate plan. I disagree. I would hold that it was error for the district court to uphold summary judgment in favor of Stern where the Trustee presented evidence of fraud, beyond the mere transfer of property on the eve of bankruptcy.

A transfer may be avoided under California law if it was made with the "actual intent to hinder, delay, or defraud any creditor of the debtor," or if it was made "without receiving a reasonably equivalent value in exchange for the transfer" Cal. Civ. Code § § 3439.04 & 3439.05 (West 2002); Maddox v. Robertson (In re Prejean, 994 F.2d 706, 708-09 (9th Cir. 1993). A transfer may also be avoided where there is actual fraud. Love v. Menick, 341 F.2d 680, 682-83 (9th Cir. 1965); [*19] In re Moffat, 107 B.R. 255, 266 (Bankr. C.D. Cal. 1989). Fraudulent intent may be shown through circumstantial evidence of actual intent to defraud, or "badges of fraud." Badges of fraud include:

(1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and, after the transfer, (5) retention by the debtor of the property involved in the putative transfer.

The presence of a single badge of fraud may spur mere suspicion; the confluence of several can constitute conclusive evidence of actual intent to defraud, absent "significantly clear" evidence of a legitimate supervening purpose.

Acequia Inc. v. Clinton (In re Acequia Inc.), 34 F.3d 800, 806 (9th Cir. 1994) (emphasis and citations omitted); see also Cal. Civ. Code § 3439.04 (referring in comment (5) to the consideration courts give to the "badges of fraud").

Citing to this court's opinion in Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971), [*20] the majority writes; "Here, the principal evidentiary inference relied upon by the Trustee is that non-exempt assets were converted to exempt assets immediately prior to bankruptcy. But, as Wudrick demonstrates, this inference is insufficient as a matter of law to establish a fraudulent conveyance. "Majority opinion at p. 1543.

I respectfully disagree with my esteemed colleagues that *Wudrick* is determinative. It can readily be distinguished from the instant case. In *Wudrick*, Mr. and Mrs. Roon, after consulting experienced bankruptcy lawyers, refinanced their 1966 Chevrolet automobile. *Id.* at 989. The bank loaned them 2,325 dollars on the car. The Roons used these funds to pay off their previous car loan and their attorney's fees. *Id.* They also deposited 800 dollars in a savings and loan association. *Id.* They then filed bankruptcy petitions. They claimed that the 800 dollar account was exempt from distribution under California law and the Bankruptcy Act. *Id.*

In a companion case, the record showed that Wudrick, on the advice of bankruptcy counsel, obtained a 2,197 dollar loan from a finance company on two vehicles about three weeks before [*21] filing his bankruptcy petition. *Id.* He put 1,300 dollars in a credit union. Such funds are exempt from distribution under California law. *Id.*

The Trustee argued in Wudrick that "conversion of nonexempt assets to exempt assets on the eve of bankruptcy by creation of a secured debt and deposit of the proceeds in an exempt account is fraudulent as a matter of law and therefore a claim of exemption based on such a transfer is invalid." Id. at 990. In rejecting this argument, we held that "it has long been the rule in this and other jurisdictions that the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se." Id. at 989 (citing In re Dudley, 72 F. Supp. 943, 945-947 (D. Cal. 1947), affd per curiam, Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948); Love v. Menick, 341 F.2d 680, 682-683 (9th Cir. 1965)).

The actual holding in Wudrick reads as follows:

Since no more is shown in either case than the intentional conversion of nonexempt property to exempt property, Love v. Menick, supra, controls.

A different [*22] case would be presented if on the eve of bankruptcy a debt were created with no intention of repaying the creditor, either by purchasing goods on credit or borrowing money without security. See Love v. Menick, supra, at 682-683 of 341 F.2d

Wudrick, 451 F.2d at 990.

There is no showing in this matter that Stern consulted an experienced bankruptcy attorney before he transferred the funds from his IRA into the exempt Plan. He therefore cannot prevail on the argument that he acted in good faith reliance on the advice of his attorney when

he transferred the funds and therefore lacked the intent required to deny him a discharge of his debts. See Adeeb v. Adeeb (In re Adeeb), 787 F.2d 1339, 1343 (9th Cir. 1986) (discussing the effect of a debtor's good faith reliance on an attorney's advice). Furthermore, the Trustee presented evidence that he did more than purposefully convert his assets on the eve of bankruptcy.

The Trustee presented evidence that Stern: (1) was sued and lost the arbitration before transferring the funds to the Plan; (2) testified inconsistently as to his motive for transferring [*23] the funds to the Plan; (3) may have, as a result of the 4.5 million dollar arbitration award levied against him, been insolvent when he made the transfer; (4) transferred the funds to the Plan to benefit him and his wife; (5) transferred all or substantially all of his property into the plan; and (6) retained control of the funds following the transfer. This evidence demonstrates the presence of several badges of fraud, including actual litigation against Stern, transfer of substantially all of Stern's property, insolvency, and retention of control over the funds after the transfer. This evidence supports an inference of fraudulent intent.

In Wudrick, we cited Love v. Menick for the rule regarding the purposeful conversion of nonexempt assets to exempt assets. Wudrick, 451 F.2d at 989-90. In Love, we noted that in In re Martin, 217 F. Supp. 937 (D. Oregon 1983), the district court cited the prevailing rule "that the purchase of exempt property by an insolvent debtor on the eve of bankruptcy will not, in itself, permit the trustee to disallow the claimed exemption." Love, 341 F.2d at 683 (internal quotations omitted). [*24] The district court held in In re Martin, however, that substantial evidence in the record supported the referee's finding of fraudulent intent and action. Love, 341 F.2d at 683. In reconciling the Martin decision with the "prevailing rule," we commented in Love:

To harmonize the court's decision with its recognition of the force of ... the "prevailing rule," we must assume that the record in *Martin* contained some quality of "substantive evidence" of fraudulent intent which we cannot find in the record of the case at hand.

Love, 341 F.2d at 683; see also In re Dudley, 72 F. Supp. 943, 945-47 (S.D. Cal. 1947) (discussing the "prevailing rule").

Thus, the law of this circuit as reflected in *Wudrick*, and *Love* is as follows: "the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se." *Wudrick*, 451 F.2d at 989. The term "per se" is defined as: "of in, or by

itself; standing alone, without reference to additional facts." Black's Law Dictionary 1162 (7th ed. 1999). Therefore, where substantial evidence in the [*25] record supports a finding of the debtor's fraudulent intent, property transferred on the eve of bankruptcy is not exempt from distribution to creditors. See Tavenner v. Smoot, 257 F.3d 401, 406-09 (4th Cir. 2001) (holding that "transfers of exemptible property are amenable to avoidance and recovery actions by bankruptcy trustees," and that "such transfers surely can be characterized as fraudulent, so long as the debtor had the requisite fraudulent intent"); Ford v. Poston, 53 B.R. 444, 448, 449-50 (D. Va. 1984) (stating the general rule that "in the eleventh hour a debtor may convert a part of his property which is not exempt into exempt items for the purpose of placing the property out of reach of his creditors when he claims the exemption," and stating that "the courts have long recognized a limitation of this rule: If the evidence reveals fraud apart and distinct from the mere transfer of non-exempt property into exempt, the debtor has transferred the property with the intent to defraud, hinder, or delay his creditors."); In re Krantz, 97 B.R. 514, 522 (Bankr. N.D. Iowa 1989) (discussing the rule that "the act of [*26] converting non-exempt property to exempt property is not enough to deny the exemption," but "the actual intent to hinder, delay or defraud one's creditors is sufficient to deny an exemption," and that "because intent to hinder, delay or defraud is so difficult to prove directly, the Iowa Supreme Court relies on 'badges or indices of fraud' to determine the debtor's intent."). I note that this court's use of the term "per se" in setting forth the rule in Wudrick that "the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se," is significant. The words "per se" should not be ignored. n1

n1 At oral argument, Stern's attorney quoted *Wudrick*, and attempted to convince this Court that the words "per se" were superfluous:

"The purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent per se." And what he [Mr. Burstein, Appellant's counsel] seems to be saying if I understand him is those two words, "per se," at the end may open up some door, though I've already answered if you assume that opens up a door what could there be behind that door? And the answer is, nothing that changes it. But what's interesting in terms of case analysis, if you take those two words off of there, I can't imagine he could even make the argument, and if Wudrick



read, "It has long been the rule that the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not fraudulent," period ... I can't even imagine that this would be considered anything but a pure reversal of *Wudrick*, and to suggest that those two words there in that context really mean anything but that, alternatively, is not per se fraudulent. Well, would that open a door? The test has to be what could be behind that door ...

[*27]

Because the Trustee presented genuine issues of material fact regarding whether Stern acted with fraudulent intent when he transferred funds from his IRA, which were exempt only to the extent necessary to support him in his retirement, into exempt funds under the Plan, I would reverse the judgment of the district court and remand for a trial and findings on the question whether Stern intended to hinder, delay, or defraud his creditors.

In re MARVIN JAMES CRATER and FAY B. CRATER, Debtors. JAMES D. MURPHEY, Plaintiff, vs. MARVIN JAMES CRATER and FAY B. CRATER, husband and wife, Defendants.

Chapter 7, CASE NO. 01-12851-PHX-RJH, ADVERSARY NO. 02-00007

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF ARIZONA

286 B.R. 756; 2002 Bankr. LEXIS 1602

December 17, 2002, Decided

December 17, 2002, Filed

DISPOSITION:

[**1] Murphey's motion for summary judgment denied.

CASE SUMMARY

PROCEDURAL POSTURE: Plaintiff creditor objected to discharge due to the debtors' prebankruptcy sale of an asset and use of the proceeds to increase an exemption. The objecting creditor sought summary judgment on his objection to discharge.

OVERVIEW: The creditor established that (1) the debtors sold an asset, stock worth about \$ 40,000, shortly after being served with suit, (2) the asset was their only significant, unencumbered nonexempt asset, and (3) the sale of the asset and the use of the proceeds to pay down a second home mortgage and thereby increase the equity protected by the homestead occurred shortly before the filing of bankruptcy and, implicitly, while insolvent. Thus, the creditor established badges of fraud 4, 5, and 9, all of them in the third category of such badges. Notably, none of the badges established was implicitly indicative of fraudulent intent. The determinative issue was whether proof of one or more of the badges of fraud could be used to infer the extrinsic actual fraud that was required to deny a discharge to a debtor who converted nonexempt into exempt assets. The court held that neither timing factors nor uneconomic decision-making by debtors was sufficient to deny a discharge on account of knowledgeable exemption planning. Analysis suggested an even stronger rule. The creditor made no showing of a badge of fraud falling in the first category.

OUTCOME: The creditor's motion for summary judgment was denied.

LexisNexis(TM) HEADNOTES - Core Concepts

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN1] Denial of discharge is a harsh result. In keeping with the fresh start purposes behind the Bankruptcy Code, courts should construe 11 U.S.C.S. § 727 liberally in favor of debtors and strictly against parties objecting to discharge.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN2] See 11 U.S.C.S. § 727(a)(2)(A).

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN3] To a deny a discharge under 11 U.S.C.S. § 727(a)(2)(A), the intent must be actual intent, as constructive fraudulent intent cannot be the basis for denial of a discharge. But that requisite intent need only be shown by a preponderance of the evidence, not the heightened standard the common law often requires for a showing of fraud. And an intent to defraud need not be shown, as intent to hinder or delay is sufficient. That intent, though it must be actual, may be inferred from the circumstances surrounding the transaction.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN4] Regarding denial of discharge under 11 U.S.C.S. § 727(a)(2)(A), the plaintiff, of course, always has the ultimate burden of proof. Fed. R. Bankr. P. 4005. But depending on the procedural context, there are at least three possibly applicable evidentiary standards.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge Civil Procedure > Summary Judgment > Summary Judgment Standard

[HN5] The highest evidentiary standard is that required of a plaintiff to obtain summary judgment when the

debtor has denied any fraudulent intent, because the court must then be convinced that no fact finder could infer that the debtor's intent was innocent. But generally scienter should not be resolved by summary judgment, so credibility issues are to be left to the trier of fact to resolve on the basis of oral testimony except in extreme cases. On a motion for summary judgment, a plaintiff must satisfy that highest standard. Mere presentation of facts that could sustain a factual finding of fraudulent intent, or even establishment of a prima facie case, will not necessarily be sufficient to win summary judgment, if on such undisputed facts a fact finder could infer that the debtor's intent was innocent.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN6] Even though an actual intent to convert nonexempt assets into exempt assets shortly before filing bankruptcy is necessarily an intent to hinder or delay creditors, such intent and conversion by themselves do not compel denial of discharge under 11 U.S.C.S. § 727(a)(2)(A).

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN7] When a debtor is insolvent, the payment of any one creditor may inherently delay others, and that may even be the debtor's actual intent in paying the one creditor, either to increase the equity in an exempt asset, or simply to prefer that creditor over others. And yet it has always been the law that such an intent to prefer one creditor, while delaying others, does not make a preference into a fraudulent conveyance, even though it would technically fit the terms of that statute. If the debtor is aware that it will necessarily have that result, the transfer would seem to be made with an intent to hinder, delay and defraud other creditors; yet the securing or paying of an actual debt, in good faith, without any design injurious to creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law and the statute of Elizabeth. Nor is it so under the Bankruptcy Act.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN8] In 11 U.S.C.S. § 727(a) proceedings, many courts disregard both the amount claimed exempt and any evidence of the debtor's desire to shield assets, instead denying discharge only where the debtor has committed some act extrinsic to the conversion which hinders, delays or defrauds.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN9] The badges of fraud are not codified as appropriate grounds for denial of discharge pursuant to 11 U.S.C.S. § 727(a)(2)(A). But they have been long

recognized at common law as grounds for finding the identical statutory element that is found in § 727(a)(2)(A)--actual intent to hinder, delay or defraudwhen it is an element of a fraudulent transfer.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN10] The badges of fraud may be categorized into three types. Some of the badges are themselves indicative of concealment, deception or fraudulent intent: the debtor retained possession or control of the property transferred after the transfer; the transfer or obligation was concealed; the debtor absconded; and the debtor removed or concealed assets.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN11] A second category of badges of fraud consists of three of them that do not implicitly suggest fraud but do suggest there must have been a motivation other than the transaction itself because it was not an economically rational decision for a debtor to make but for its effect to hinder or delay creditors: the transfer or obligation was to an insider; the value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; and the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN12] The third category of badges of fraud consists of badges that may be innocent in themselves, or are merely timing factors that become suspicious only when combined with other factors: before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; the transfer was of substantially all of the debtor's assets; the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; and the transfer occurred shortly before or shortly after a substantial debt was incurred.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN13] The court tentatively concludes that those badges of fraud that are not intrinsically indicative of fraudulent intent are not sufficient evidence of actual fraud to compel a denial of discharge. To be more precise, those badges of fraud that fall into the second and third categories are neither sufficient to sustain summary judgment for the creditor, nor to shift the burden of going forward to the debtor. In short, they do not establish a prima facie case for denial of discharge, even when conjoined with prebankruptcy exemption planning. They really do nothing more than demonstrate that the debtor engaged in otherwise permissible exemption planning

only when it became apparent that it would be intelligent to do so, and was willing to sacrifice some asset values to achieve the exemption.

Governments > Legislation > Interpretation

[HN14] It is inappropriate for judges to determine when pigs become hogs when the legislature has failed to do so and has not invited the courts to exercise that judgment.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN15] Neither timing factors nor uneconomic decision-making by debtors is sufficient to deny a discharge on account of knowledgeable exemption planning.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge Civil Procedure > Summary Judgment > Summary Judgment Standard

[HN16] Regarding a creditor's objection to discharge pursuant to 11 U.S.C.S. § 727(a)(2)(A), it might be sufficient to deny summary judgment in favor of the creditor on the basis that the requisite fraudulent intent is so individualistic and fact based that it cannot be determined without live testimony and the opportunity to judge the credibility of the debtor.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN17] Unless the creditor shows a deception or concealment, an insider transaction, a fraudulent conveyance, a secretly retained possession or benefit, or debtor explanations that lack credibility, the second and third categories of badges of fraud are not sufficient to shift to the debtor the burden of going forward, even if all of the debtor's nonexempt assets were converted into exempt assets just after being sued and just before filing bankruptcy.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN18] Congress did not invite bankruptcy judges to grant or deny the discharge based on an amorphous, individualistic finding such as "reasonable" or "good faith." Instead, it made the requisite determination hinge on intent, something that common law precedent has successfully refined over the centuries, particularly in tort law and in criminal law. Consequently, is it appropriate for courts to seek to refine and define the requisite intent, so that the evolution of precedent may in the long rung yield predictable, practical rules.

Bankruptcy Law > Chapter 7 (Liquidation) > Discharge [HN19] Both the second and third categories of the badges of fraud merely underscore that the debtor intended to take advantage of available exemptions. The timing factors make that more evident than if the exempt property were purchased before bankruptcy was

imminent, and engaging in an otherwise uneconomic transaction eliminates another possible motive, but neither of these makes the intent any more than an intent to utilize available exemptions. And since all authorities (except perhaps the United States Court of Appeals for the Eighth Circuit) agree that that intent is not penalized or forbidden by 11 U.S.C.S. § 727(a)(2)(A), that intent is not transformed into something more evil by its timing or even by the size of the transaction.

COUNSEL:

Tim D. Coker, Esq., Robert Mothershead, P.C., Phoenix, AZ, for Plaintiff/ Creditor.

William F. Doran, Esq., Phoenix, AZ, for Defendants/Debtors.

Louis Movitz, Chapter 7 Trustee, Carefree, AZ.

JUDGES:

RANDOLPH J. HAINES, United States Bankruptcy Judge.

OPINIONBY:

RANDOLPH J. HAINES

OPINION:

[*758] OPINION RE: OBJECTION TO DISCHARGE

This case concerns an objection to discharge due to the debtors' prebankruptcy sale of an asset and use of the proceeds to increase an exemption. The objecting creditor seeks summary judgment on his objection to discharge. Because the Court finds the undisputed facts do not establish any improper intent to hinder, delay or defraud creditors, other than an intent to utilize available exemptions when the need to do so became evident, the motion for summary judgment is denied.

Facts

The following facts are undisputed.

On July 12, 2001, Marvin and Fay Crater ("Debtors") were served with a suit filed by creditor James Murphey ("Murphey") for royalties due under a patent license. Murphey obtained a default judgment in that suit for more than \$ 600,000 in October, 2001, although that judgment was subsequently [**2] vacated because it had been entered in violation of the automatic stay.

Debtors retained a bankruptcy attorney on July 26, 2001, who sent a letter informing Murphey that he had been retained to file Chapter 7 for the Debtors. On or about that same day the Debtors sold some stock they owned in Krispy Kream for about \$ 40,000. On September 10, 2001, the Debtors used the proceeds of that sale to pay Chase Manhattan Mortgage ("Chase") approximately \$ 40,000, which largely satisfied a second mortgage Chase held against their home. Debtors filed [*759] this Chapter 7 case 17 days later, on September 27, 2001.

Murphey filed a timely complaint objecting to the Debtors' discharge. Among other grounds, the complaint objected pursuant to 11 U.S.C. § 727(a)(2)(A), n1 on the ground that the sale of the Krispy Kream stock was made with "intent to hinder, delay, or defraud a creditor," by essentially converting Debtors' nonexempt asset into an increased homestead exemption. Arizona has opted out of the federal exemptions n2 and permits a homestead exemption up to \$ 100,000 in equity. n3 Debtors' Schedule D claims their home is worth \$ 100,000 and is subject to a \$ 32,700 first lien [**3] and a \$ 2,577 second lien held by Chase. Consequently their current homestead exemption is approximately \$ 64,712 in equity, whereas but for the application of the stock sale proceeds it would have been only \$ 24,232, and the Chapter 7 Trustee would have had an additional \$ 40,000 of unencumbered assets to distribute to creditors.

n1 Unless otherwise noted, all statutory and rule references are to the United States Bankruptcy Code, 11 U.S.C. § § 101-1330, and the Federal Rules of Bankruptcy Procedure.

n2 Arizona Revised Statutes ("A.R.S.") § 33-1133(B).

n3 A.R.S. § 33-1101(A).

Murphey moved for summary judgment. His principal argument is that actual intent to hinder, delay or defraud creditors can be shown by circumstantial evidence, and that it is shown by the "badges of fraud" because the Debtors sold essentially all their nonexempt assets shortly after being sued, and used the proceeds to increase their homestead exemption shortly before filing bankruptcy. n4

n4 There is some indication in Murphey's motion that the transfer did not in fact occur until after the petition was filed. Debtor denies that,

however, so to the extent Murphey relies on that argument there is a material issue of fact that precludes summary judgment.

[**4]

General Principles

The question of whether a discharge should be denied because a debtor converted nonexempt assets into exempt assets shortly before filing has been addressed in some significant cases in other circuits. See, e.g., Smiley v. First Nat'l Bank of Belleville (In re Smiley), 864 F.2d 562 (7th Cir. 1989); Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988); Hanson v. First Nat'l Bank in Brookings, 848 F.2d 866 (8th Cir. 1988); Ford v. Poston (In re Ford), 773 F.2d 52 (4th Cir. 1985); First Texas Sav. Assoc., Inc. v. Reed (In re Reed), 700 F.2d 986 (5th Cir. 1983). But it does not appear to have been addressed by the Ninth Circuit at least since the adoption of the Bankruptcy Code.

There is, however, substantial Ninth Circuit case law addressing the elements, evidentiary standards, and burden of proof for denial of discharge under § 727(a)(2)(A).

[HN1] "Denial of discharge is a harsh result." Bernard v. Sheaffer (In re Bernard), 96 F.3d 1279, 1283 (9th Cir. 1996). "In keeping with the 'fresh start' purposes behind the Bankruptcy Code, courts should [**5] construe § 727 liberally in favor of debtors and strictly against parties objecting to discharge." Id. at 1281, citing Devers v. Bank of Sheridan, Montana (In re Devers), 759 F.2d 751, 754 (9th Cir. 1985).

Section 727(a)(2)(A) provides that a debtor may be denied a discharge if [HN2] "the debtor, with intent to hinder, delay, or defraud a creditor, ... has transferred ... property of the debtor, within one year before the date of the filing of the petition; [*760] ..." Here is it undisputed that the Debtors transferred their Krispy Kream stock within one year of the petition, so the only issue is whether such transfer was made with the requisite "intent to hinder, delay or defraud a creditor."

[HN3] To a deny a discharge under § 727(a)(2)(A), the intent must be actual intent, as "constructive fraudulent intent cannot be the basis for denial of a discharge." First Beverly Bank v. Adeeb (In re Adeeb), 787 F.2d 1339, 1343 (9th Cir. 1986); Devers, 759 F.2d at 753. But that requisite intent need only be shown by a preponderance of the evidence, not the heightened standard the common law often requires for a showing of fraud. Grogan v. Garner, 498 U.S. 279, 284, 112 L. Ed.

2d 755, 111 S. Ct. 654 (1991). [**6] And an intent to defraud need not be shown, as "intent to hinder or delay is sufficient." Bernard, 96 F.3d at 1281. That intent, though it must be actual, may be inferred "from the circumstances surrounding the transaction." Emmett Valley Assocs. v. Woodfield (In re Woodfield), 978 F.2d 516, 518 (9th Cir. 1992).

Although the "badges of fraud" that were recognized at common law and are now codified in the Uniform Fraudulent Transfer Act n5 for finding an actual fraudulent conveyance are not codified in the Bankruptcy Code either for that purpose or for denial of discharge under § 727(a)(2)(A), Woodfield seems to suggest that they are at least appropriate circumstances that may be considered as a basis to infer that intent. Id. Indeed, that opinion could be read to say that the presence of some of the badges of fraud maybe sufficient to infer the requisite intent "unless some other convincing explanation appears." Id. But that was dictum because the opinion also noted that "more than a dry checklist of badges of fraud demonstrates the Debtor's intent, however," because those debtors admitted they "were trying to delay or prevent seizure [**7] of the assets," and they omitted them from their statement of affairs. Id. at 519.

n5 See, e.g., A.R.S. § 44-1004(B), codifying UFTA § 4(b):

"In determining actual intent under subsection A, paragraph 1, consideration may be given, among other factors, to whether:

- 1. The transfer or obligation was to an insider.
- 2. The debtor retained possession or control of the property transferred after the transfer.
- 3. The transfer or obligation was disclosed or concealed.
- 4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
- 5. The transfer was of substantially all of the debtor's assets.
 - 6. The debtor absconded.
 - 7. The debtor removed or concealed assets.
- 8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.

- 9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- 10. The transfer occurred shortly before or shortly after a substantial debt was incurred.
- 11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."

[**8]

Evidentiary Standards

[HN4] The plaintiff, of course, always has the ultimate burden of proof. Bankruptcy Rule 4005. But depending on the procedural context, there are at least three possibly applicable evidentiary standards. The lowest of them is when the bankruptcy court has conducted a full trial and found that the discharge should be denied. Because the standard of review on appeal for the factual finding of the requisite intent is the clearly erroneous standard, Devers, 759 F.2d at 753, it will take only a modicum [*761] of evidence of fraudulent intent to sustain the bankruptcy court's finding. Possibly equal to that standard, but possibly a higher standard, is the strength of the evidence necessary at trial to shift the burden of going forward from the plaintiff to the debtor, to explain the innocence of his transactions and intent. The Fifth Circuit described that point as when plaintiff "makes a prima facie case." Reed, 700 F.2d at 992. In this precise context, Reed held that it is only upon a showing of fraud by the creditor, that the burden shifts to the Debtor to explain the transaction. Id. Finally, [HN5] the highest standard is that [**9] required of a plaintiff to obtain summary judgment when the debtor has denied any fraudulent intent, because the court must then be convinced that no fact finder could infer that the debtor's intent was innocent. But generally "scienter should not be resolved by summary judgment," Provenz v. Miller, 102 F.3d 1478, 1489 (9th Cir. 1996), so "credibility issues are to be left to the trier of fact to resolve on the basis of oral testimony except in extreme cases." In re Chavin, 150 F.3d 726, 728 (7th Cir. 1998)(emphasis in original).

Because this is summary judgment, plaintiff must satisfy that highest standard. Mere presentation of facts that could sustain a factual finding of fraudulent intent, or even establishment of a prima facie case, will not necessarily be sufficient to win summary judgment, if on such undisputed facts a fact finder could infer that the debtor's intent was innocent.

Exemption Planning Is Permissible, Absent Extrinsic Fraud

So far as this Court has seen, the authorities are unanimous that [HN6] even though an actual intent to convert nonexempt assets into exempt assets shortly before filing bankruptcy is necessarily [**10] an intent to hinder or delay creditors, such intent and conversion by themselves do not compel denial of discharge under § 727(a)(2)(A). The Ninth Circuit Bankruptcy Appellate Panel has so held. Coughlin v. Cataldo (In re Cataldo), 224 B.R. 426, 429 (9th Cir. BAP 1998), quoting Roosevelt v. Ray (In re Roosevelt), 176 B.R. 200, 208 (9th Cir. BAP 1994)("It is clear that in the Ninth Circuit a debtor may convert non-exempt property into exempt property even on the eve of bankruptcy.")(dictum). This is because such a conclusion would be contrary to the very purpose of providing exemptions, and because the ability to make intelligent use of the exemptions was specifically addressed and permitted by the legislative history of the Code:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing of the bankruptcy petition. This practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law. (Emphasis in original).

H.R. REP. 95-595, at 361 (1977), reprinted in, 1978 U.S.C.C.A.N. 5963, 6317; S. REP. No. [**11] 95-989 at 76 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5862, quoted in, Tveten, 848 F.2d at 874; Reed, 700 F.2d at 990; and Cataldo, 224 B.R. at 429.

In this case, the exemption planning occurred by payment of a valid debt. This creates a second reason why such exemption planning is not fraudulent. [HN7] When a debtor is insolvent, the payment of any one creditor may inherently delay others, and that may even be the debtor's actual intent in paying the one creditor, either to increase the equity in an exempt asset such as here, or simply to prefer that creditor over others. And yet it has always been the law that such an intent to prefer one creditor, while delaying others, does not make a preference into a fraudulent conveyance, [*762] even though it would technically fit the terms of that statute. n6 Coder v. Arts, 213 U.S. 233, 53 L. Ed. 772, 29 S. Ct. 436 (1909)(construing Act § 67e); Irving Trust Co. v. Chase Nat'l Bank, 65 F.2d 409, 410 (2d Cir. 1933)("Pro tanto every preference hinders and delays [other creditors]. If the debtor is aware that it will necessarily have that result, the transfer [**12] would seem to be made with an intent to hinder, delay and defraud other creditors; yet the securing or paying of an actual debt, in good faith, without any design injurious to creditors beyond that implied in giving the preference, was not deemed a fraudulent conveyance under the principles of the common law and the statute of Elizabeth. Nor is it so under the Bankruptcy Act." (citations omitted)); 4 COLLIER ON BANKRUPTCY P 67.37, at 535 (14th ed. 1978)("The intent to delay or hinder seemingly implicit in any preferential transfer by an insolvent debtor has, however, been held not to constitute the actual fraudulent intent required under former § 67e [the attempted codification of Dean v. Davis, 242 U.S. 438, 61 L. Ed. 419, 37 S. Ct. 130 (1917)]. This interpretation of the familiar words, 'with intent to hinder, delay or defraud,' surely holds true for [Act] § 67d(2)(d) [actual fraudulent conveyance]."); II GERRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 382, at 662 (rev. ed. 1940)("[A] preference cannot be turned into a fraudulent conveyance by a mere finding that the debtor intended to defraud his creditors, if the other findings show only [**13] a preference and nothing more.").

n6 There is now an exception to this broad statement in states that have adopted the Uniform Fraudulent Transfer Act § 5 as originally drafted, which makes insider preferences fraudulent. Section 5(b) of the UFTA provides: "A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider has reasonable cause to believe that the debtor was insolvent." Arizona, however, did not adopt that provision. See A.R.S. § 44-1005 (codifying UFTA § 5(a) and eliminating § 5(b)).

The circuit courts that have addressed the issue also agree, however, that such a conversion of nonexempt into exempt assets can result in the denial of the discharge if there was extrinsic evidence of actual intent to defraud. Reed, 700 F.2d 986; accord, Tveten, 848 F.2d at 874 (discharge may be denied "if there was [**14] extrinsic evidence of the debtor's intent to defraud creditors"); Cataldo, 224 B.R. at 430 [HN8] ("[In] Section 727(a) proceedings, many courts disregard both the amount claimed exempt and any evidence of the debtor's desire to shield assets, instead denying discharge 'only where the debtor has committed some act extrinsic to the conversion which hinders, delays or defrauds," quoting, Smiley, 864 F.2d at 567). n7

n7 While the circuits are in apparent agreement on this principle, none of them seems to have noticed the difference between the Seventh Circuit's rule as stated in *Smiley*, which requires an extrinsic *act*, and the Fifth and Eighth Circuit formulations, which only require extrinsic *evidence* of the prohibited intent. Here, there is no act extrinsic to the conversion of exempt into nonexempt assets, yet the creditor argues that the timing of that act is such evidence of the prohibited intent. But if an extrinsic fraudulent or delaying act is required, why is not that act alone sufficient to deny the discharge wholly apart from the exemption planning?

[**15]

These principles also reflect the law of the Ninth Circuit under the Act, which the legislative history quoted above was intended to incorporate into the Code. n8 Under [*763] the Act, the Ninth Circuit held that the mere conversion of nonexempt assets to exempt assets, even on the eve of bankruptcy, would not without more result in a denial of the exemption. n9 E.g., Wudrick v. Clements, 451 F.2d 988 (9th Cir. 1971)(upholding exemption for money borrowed against unencumbered vehicles and placed into a credit union where it was exempt under California law); Goggin v. Dudley, 166 F.2d 1023 (9th Cir. 1948), aff'g 72 F. Supp. 943 (S.D. Cal. 1947)(upholding exemption for \$ 1,000 of exempt Building and Loan Association stock purchased one week prior to voluntary petition). But the exemption could be denied if there was other evidence of actual fraud. For example, if the money invested into an exempt asset were derived from the sale of stock that had been pledged to a bank and released on the debtor's fraudulent promise to apply the proceeds to the bank's loan, the trustee could use the strong arm clause to assert the rights of the defrauded bank [**16] and avoid the debtor's claimed homestead exemption. Miguel v. Walsh, 447 F.2d 724 (9th Cir. 1971).

n8 In fact, one authority suggests that it was precisely these Ninth Circuit cases that were referred to in the legislative history quoted above, based on a letter from a California bankruptcy judge, who described this state of the law in the Ninth Circuit and noted the law was "in a state of utter confusion in other circuits." In re Kravitz, 225 B.R. 515, 518 (Bankr. D. Mass. 1998).

n9 These Ninth Circuit authorities under the Act technically dealt only with objections to the claimed exemption. For opt-out states under the Code, the availability of the exemption should be controlled by state law, whereas the denial of 727(a)(2) is governed by discharge under § federal law. This distinction is implicit in Cataldo, and is well illustrated by the two decisions in Reed, one of which upheld the exemption, and the other of which denied the discharge. Driskill v. Reed (In re Reed), 12 B.R. 41 (Bankr. N.D. Tex. 1981) and Reed, 700 F.2d 986. But the legislative history that all the authorities rely on, which says the conversion of nonexempt property into exempt property is not fraudulent as to creditors, really speaks to the § 727 issue and therefore makes these Ninth Circuit cases applicable to the § 727 context.

[**17]

The Ninth Circuit authority most expansive on this issue is Goggin v. Dudley, which adopted the opinion of the District Court. In that case the debtor had purchased \$ 1000 of exempt stock in a building and loan association just one week prior to filing a voluntary petition, when he was "heavily in debt and clearly insolvent." 72 F. Supp. at 944. The Trustee denied the exemption, which was affirmed by the Referee, but then reversed by the District Court, which was upheld by the Ninth Circuit. In reversing, the District Court noted that "If the mere acquisition of exempt property while insolvent were sufficient ground to destroy the exemption, the acquisition of any such property, within the four-months' period, could be nullified, and the protection which the state law gives to a debtor, even against the solemn money judgement of a court, would be denied him against creditors in bankruptcy." Id. at 947. And in response to the Referee's focus on the acquisition while insolvent, the District Court held that if such a fact could render the exemption fraudulent, it would read into the exemption restrictions that were not there:

[The California [**18] exemption statute] does not say when building and loan stock must be acquired in order to be exempt. Nor does it say that the person shall be solvent at the time of acquisition. To sustain the Referee in this case, we would have to impose a time limit and make solvency a condition precedent to exemption. This would mean reading into the state statute restrictions which are not there. And this we cannot and should not do. And, as there is no showing of actual fraud, the stock

is immune against the creditors and never passed to the trustee.

[*764] *Id. at 947.* The opinion had earlier summarized this conclusion: "The doctrine bearing upon conveyances made to hinder, delay, or defraud creditors has no application to the creation of a homestead." *Id. at 946.*

The issue these authorities leave open, and the determinative issue here, is whether proof of one or more of the badges of fraud may be used to infer the extrinsic actual fraud that is required to deny a discharge to a debtor who converted nonexempt into exempt assets.

Certain Badges of Fraud Alone Do Not Imply Actual Fraud

As noted above, [HN9] the "badges of fraud" are not codified as appropriate [**19] grounds for denial of discharge pursuant to § 727(a)(2)(A). But they have been long recognized at common law as grounds for finding the identical statutory element that is found in § 727(a)(2)(A) -- "actual intent to hinder, delay or defraud" -- when it is an element of a fraudulent transfer. And Woodfield suggests, but does not hold, that the badges of fraud are relevant considerations for purposes of § 727(a)(2)(A).

The question is whether some of them, or which of them, may be sufficient to find the "actual fraud" that must accompany a conversion of nonexempt into exempt assets if it is to result in a denial of discharge.

[HN10] The badges of fraud may be categorized into three types. Some of the badges are themselves indicative of concealment, deception or fraudulent intent: 2. The debtor retained possession or control of the property transferred after the transfer; n10 3. The transfer or obligation was ... concealed; 6. The debtor absconded; and 7. The debtor removed or concealed assets.

n10 Transfer without change of possession was considered fraudulent at the inception of fraudulent conveyance law over 400 years ago. See Twyne's Case, 3 Coke Rep. 80b (1601). See also A.R.S. § 44-1061(A): "A sale made by a vendor of goods and chattels ..., unless the sale or assignment is accompanied by an immediate delivery and followed by an actual and continued change of possession of the things sold or assigned, is prima facie evidence of fraud against creditors of the vendor"

[HN11] A second category of badges consists of three of them that do not implicitly suggest fraud but do suggest there must have been a motivation other than the transaction itself because it was not an economically rational decision for a debtor to make but for its effect to hinder or delay creditors: 1. The transfer or obligation was to an insider; n11 8. The value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; 11. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

not seek to maximize his economic benefit by exposing the asset to the market to obtain the highest possible price. But it could also fall in the first category, because insider sales may also facilitate a secret retention of possession, control or benefit. Of course it could also evidence an intent to benefit the insider, a potential classic fraudulent conveyance if made while insolvent without receipt of fair equivalent value. And under UFTA § 5(b), even payment of a valid insider debt while insolvent may be fraudulent. See note 6 supra.

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[HN12] The third category, however, consists of badges that may be innocent in themselves, or are merely timing factors that become suspicious only when combined with other factors: 4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; 5. The transfer was of substantially [*765] all of the debtor's assets; 9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; and 10. The transfer occurred shortly before or shortly after a substantial debt was incurred.

Here, the plaintiff creditor has established only that (1) the Debtors sold the asset shortly after being served with suit, (2) the asset was the Debtors' only significant, unencumbered nonexempt asset, and (3) the sale of the asset and the use of the proceeds to pay down a second home mortgage and thereby increase the equity protected by the homestead occurred shortly before the filing of bankruptcy and, implicitly, while insolvent. Thus the creditor has established badges 4 and 5 and 9, all of them in the third category.

Notably, none of the badges that the creditor has established here is implicitly indicative of fraudulent

intent. [**22] They do not even fall into the second category of transactions that are suspicious because they lack an economically rational purpose. For example, the creditor has not shown that the Krispy Kream stock was appreciating, or generating dividends, in excess of the interest the debtor was paying on the second mortgage. Rather, they are merely timing factors.

If conversion of nonexempt into exempt assets should not itself result in denial of discharge, should it do so when it occurs shortly after the debtor has been sued or incurred a large debt, or is insolvent, or is about to file bankruptcy? If that were the rule, it would mean that prospective debtors could engage in exemption planning only up until the point where it appeared they might need to do so. As the court noted in Goggin v. Dudley, this would be to add a restriction to the exemption that the legislature (and Congress) did not impose, i.e., certain assets are exempt only if purchased while solvent, while not owing substantial debts, or some significant period of time prior to levy of execution or bankruptcy. It would be particularly inappropriate to impose such a judge-made time condition on an exemption, such as [**23] the homestead, when the legislature did not do so but did so with respect to other exemptions. For example, while Arizona imposes no time limit on obtaining or declaring a homestead, it does require that life insurance policies must have been continuously maintained for two years in order to be exempt, and excludes from the exemption cash surrender values that were increased by premium payments within the prior two years in excess of the average annual premium paid during the previous three vears. A.R.S. § § 33-1126(A)(6) & (B). The Arizona legislature knows how to curb abusive exemption planning when it sees the need to do so.

Moreover, if intentional conversion of nonexempt into exempt assets is not per se fraudulent as to creditors, what is the additionally fraudulent n12 nature of the intent that is evidenced by such a conversion occurring shortly after being sued, while insolvent, and shortly before filing bankruptcy? It would seem to be merely evidence that the debtor intended to maximize his assets that would be shielded from creditors, and probably had one specific creditor in mind, and probably knew that his assets were insufficient to satisfy all his creditors. But such [**24] intent is nothing more than the intent to convert nonexempt into exempt assets, which all authorities agree is not fraudulent. So how could the timing of the conversion, or the pressure of a [*766] single creditor, cause that same intent to result in a denial of discharge?

n12 The term "fraudulent" is used here generically to include also the prohibited intent to hinder or delay creditors.

Indeed, what if the transaction did not make economic sense, standing alone? The scenario is not uncommon in the exemption planning discharge cases, and it yields conflicting results even within the same circuit, as one debtor may get a discharge despite buying an exempt \$ 10,000 shotgun that he does not need, n13 but another is denied the opportunity to buy a homestead that he does not need. n14 For example, what if the Krispy Kream stock were generating income far in excess of the interest rate being paid on the second mortgage, and promised to do so for the foreseeable future? What would that say about the debtor's intent? It could [**25] certainly be argued that it disproves an "innocent" explanation of the transaction, i.e., it belies an argument that the debtor thought it was a better use of his money to pay down his homestead mortgage. But what does that prove? It proves that the intent really was to maximize the exemption, even at a sacrifice of income. But that still is nothing more than an intent to convert nonexempt into exempt assets. All that the uneconomic nature of the transaction does is highlight the strength and focus of the intent, but if the intent is not objectionable, then neither should be the same intent when strongly felt and focused on a particular creditor.

n13 In *In re McCabe, 280 B.R. 841 (Bankr. N.D. Iowa 2002)*, the debtor bought a \$ 10,000 Belgian Browning shotgun which he fired once or twice, because he knew Iowa had no dollar limit on the exemption for a family gun, and yet he was allowed his discharge.

n14 In Jensen v. Dietz (In re Sholdan), 217 F.3d 1006 (8th Cir. 2000), the ninety year old debtor moved out of assisted care facility into a homestead purchased with all his exempt assets, and the exemption was denied.

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Consequently [HN13] this Court tentatively concludes that those badges of fraud that are not intrinsically indicative of fraudulent intent are not sufficient evidence of actual fraud to compel a denial of discharge. To be more precise, those badges of fraud that fall into the second and third categories identified above are neither sufficient to sustain summary judgment for the creditor, nor to shift the burden of going forward to the

debtor. In short, they do not establish a prima facie case for denial of discharge, even when conjoined with prebankruptcy exemption planning. They really do nothing more than demonstrate that the debtor engaged in otherwise permissible exemption planning only when it became apparent that it would be intelligent to do so, and was willing to sacrifice some asset values to achieve the exemption.

This tentative conclusion must be tested against the existing case law, both in the Ninth Circuit and elsewhere.

Ninth Circuit Cases Do Not Find Timing Factors and Uneconomic Transactions Sufficient to Establish Fraud.

The tentative conclusion is certainly consistent with, if not compelled by, Ninth Circuit precedent. Goggin v. Dudley essentially rejected [**27] timing factors as a basis to deny an exemption, and given § 727's legislative history indicating an intent to preserve the existing ability to convert nonexempt into exempt assets, there is no reason to conclude the result should be different under the Code. It is also consistent with Miguel v. Walsh, where there was actual extrinsic fraud, in that the debtor fraudulently induced the bank to part with its collateral on a promise to use its sale proceeds to pay down the bank's debt. And it is not inconsistent with Woodfield, where although the court relied on many of the third category timing badges, there also existed the suggestive fraudulent element [*767] of an insider transaction, and there were explanations that lacked credibility and were therefore deceptive. See 978 F.2d at 518-19.

Wudrick could be read as establishing an even broader rule upholding exemptions and discharges. In Wudrick, the debtors in the two cases consolidated for decision both borrowed money against their cars to obtain the funds to put into the exempt credit union accounts. 451 F.2d at 989. It is highly likely, although the Ninth Circuit did not comment on it, that [**28] the interest rates the debtors had to pay on the auto loans exceeded the interest rates that could be earned on the savings accounts. If so, then the transactions were not economically rational decisions for the debtors to make, but for the obtaining of the exemption. The fact that the Ninth Circuit upheld the exemptions indicates that even the second category of badges of fraud -- noneconomic decision making -- is not sufficient to make a prima facie case to deny the discharge. Indeed, because the Ninth Circuit's opinion reversed the district court's affirmance of the referee's denial of the claimed exemption in one of the two cases, it may stand for the proposition that the

second category of badges of fraud does not even constitute evidence of the requisite fraudulent intent.

It should be remembered that these Ninth Circuit Act cases have significance beyond the Ninth Circuit, because they were apparently the Act authorities the House and Senate Reports were referring to when they said "As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing of the bankruptcy petition." n15

n15 See H.R. REP. 95-595, at 361 (1977), reprinted in, 1978 U.S.C.C.A.N. 5963, 6317; S. REP. No. 95-989 at 76 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5862, quoted in, Tveten, 848 F.2d at 874; Reed, 700 F.2d at 990; and Cataldo, 224 B.R. at 429. See note 8 supra.

[**29]

Most Other Circuit Decisions Are Consistent

The tentative conclusion is consistent with Smiley v. First Nat'l Bank of Belleville (In re Smiley), 864 F.2d 562 (7th Cir. 1989). The Seventh Circuit's analysis of the case law on this issue is useful in categorizing the cases into three camps. The first denies the discharge if the exemption planning was intentional, even without other evidence of fraud. The Seventh Circuit, like this Court, rejects that analysis as rewarding ignorant debtors and punishing knowledgeable debtors. 864 F.2d at 567. The second camp bases denial of discharge on the amount attempted to be exempted, essentially creating a judgemade cap on exemptions at the level the court concludes is necessary for the "fresh start," rather than the "head start." Id., citing In re Reed, 11 B.R. 683, 688. For the reasons eloquently set forth in the Tveten dissent, this Court agrees [HN14] it is inappropriate for judges to determine when pigs become hogs n16 when the legislature has failed to do so and has not invited the courts to exercise that judgment. n17 Finally, there [*768] are those cases, with which the Smiley court agreed, [**30] that did not limit debtors' full use of exemptions within the limits of the law. 864 F.2d at 567. The Smiley court ultimately concluded the discharge should be denied because the debtor not only invested money into an unlimited Kansas homestead, but lied to his creditors about the retained value of his assets that had been liquidated to generate those funds. Id. at 568. Because such false statements and concealment fall into the first category of fraudulent badges of fraud, it is consistent with this Court's tentative conclusion on the present facts, where there is no false statement or concealment of assets.

n16 The dissent in *Tveten* criticized the majority's reasoning by comparing it to that in *Albequerque Nat'l Bank v. Zouhar (In re Zouhar), 10 B.R. 154, 157 (Bankr. D. N.M. 1981),* where the bankruptcy court denied the discharge based on the "principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered." *Tveten, 848 F.2d at 879* (Arnold, J., dissenting).

n17 In fact, this appears to be the issue that makes this area so difficult. Virtually all of the difficult cases deal with state exemption statutes that are unlimited in amount. The cases simply do not arise with any frequency, or at least do not reach the circuit courts, when the state legislature has imposed caps on exemptions. This case, however, is an exception to that general observation.

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The conclusion is consistent with Marine Midland Bus. Loans, Inc. v. Carey, 938 F.2d 1073 (10th Cir. 1991). The facts there were essentially the same as in this case, in that nonexempt assets were liquidated and the proceeds used to reduce the mortgage on the homestead. The debtor was left with a \$ 300,000 exempt Oklahoma homestead subject only to a \$ 30,000 mortgage. Id. at 1076. The bankruptcy and district courts found there was no improper intent, and the Tenth Circuit affirmed:

The liquidation of the other assets used to pay down the home mortgage occurred over a two year period and was in the open; the activity and payment appears to be consistent with what has been approved by Congress to take advantage of exemptions. [Debtor] fully disclosed all payments and transfers in her bankruptcy schedules and at the meeting of creditors. [Debtor] retained no beneficial interest in any converted property. She did not obtain credit to purchase exempt property. Under these circumstances we cannot say that the district and bankruptcy courts erred in finding she did not intend to "hinder, delay, or defraud" her creditors or acted improperly in [**32] relation to her homestead.

Id. at 1078.

More difficult to harmonize under the analysis proposed here is Ford v. Poston (In re Ford), 773 F.2d

52 (4th Cir. 1985), but its result may have hinged primarily on the debtor's perceived lack of candor. There the debtor had owned land as his sole and separate property for over six months. When a creditor obtained a judgment against him, however, he deeded it the very next day to himself and his wife as tenants by the entireties, which under Virginia law put it beyond the reach of a creditor holding a debt against only one of the spouses. 773 F.2d at 53. After trial, the bankruptcy court denied the discharge, which the Fourth Circuit affirmed. Although the Fourth Circuit's opinion requires "extrinsic evidence of actual intent to defraud creditors," id. at 55 (emphasis in original), the bankruptcy court apparently relied almost solely on the timing of the transfer. It could be, however, that the bankruptcy court also relied on a finding that the debtor's explanation of the transaction -that he was merely correcting a mistake that had been [**33] made when he took title -incredible, and therefore the debtor testified falsely and sought to conceal his true intent. n18 The [*769] Fourth Circuit's opinion seems to suggest that was the case, by describing the debtor's explanation as "conveniently choosing to correct, at that point in time, what was then a six-month old mistake." Id. Perhaps that lack of candor could be deemed sufficient evidence falling in the first category to warrant a denial of discharge. n19

n18 Perhaps Ford counsels that it would be unwise to grant debtors summary judgment in such cases where the only badge of fraud a creditor asserts relates to timing -- because the debtor should be required to explain the transaction, and the discharge should be denied if the explanation is not credible. If so, that would mean that any badge of fraud could make a prima facie case sufficient to shift the burden of going forward to the debtor. But the rule suggested here would still mean that if the debtor testified honestly, like Mr. Tveten, then the creditor's case is insufficient to deny the discharge. But that issue is not presently before the Court, and therefore need not be decided now. [**34]

n19 Another case that may have hinged primarily on debtor's apparent lack of candor is *Pomerantz v. Pomerantz (In re Pomerantz), 215 B.R. 261 (Bankr. S.D. Fla. 1997).* In that case the debtor purchased a Florida homestead within 20 days of the plaintiff obtaining summary judgment on a \$ 250,000 debt. Debtor testified that she moved to Florida because she had received a job offer there, but then did not take the job for another 18 months, during which time she had



virtually no other income and was living off of borrowing against the exempt asset. *Id. at 264*.

The tentative conclusion is consistent with First Texas Sav. Assoc., Inc. v. Reed (In re Reed), 700 F.2d 986 (5th Cir. 1983). As a threshold matter, it should be noted that Reed was not a granting of summary judgment to the objecting creditor, but an affirmance of the bankruptcy court's denial of discharge after trial, 700 F.2d at 992, so the evidentiary standard was much lower than is required here. But the facts in Reed also clearly included some that were intrinsically [**35] indicative of fraudulent intent, and many others that were not economically rational. Reed hid accounts from his creditors and sold assets, to insiders, for less than their acquisition cost only a short time before. Certainly such facts were sufficient to sustain a trial court's factual finding of fraudulent intent, particularly when coupled with what must have been the trial court's consideration of the debtor's demeanor. n20 Such facts may even be sufficient to make a prima facie case and shift the burden to the debtor to provide the innocent explanations of the transactions, and therefore to sustain summary judgment if the debtor fails to come forth with such an explanation.

n20 When Reed could not adequately account for \$ 19,000 that he carried in cash he argued that it was but a small percentage of the amount of money he went through in that year. Reed, 700 F.2d at 989. He justified sales of assets for less than what he paid for them not long before by noting that if he had received more it would have been invested in exempt assets as well. Id. He did not explain his purchase of stock in Triple BS Corporation one month before filing bankruptcy, or the significance of the initials. Id. n.1.

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The panel decision in NCNB Texas Nat'l Bank v. Bowyer (In re Bowyer), 916 F.2d 1056 (5th Cir. 1990), would have been more difficult to harmonize with this analysis, but it was reversed en banc. 932 F.2d 1100 (5th Cir. 1991). The debtor there had liquidated nonexempt assets and used some of the proceeds on luxuries and some to pay down his homestead mortgage two weeks after engaging a bankruptcy lawyer and just two weeks before filing bankruptcy. The bankruptcy court allowed the discharge, but the Fifth Circuit panel reversed, concluding that the bankruptcy court had only found no intent to defraud, but had not addressed an intent to

916 F.2d at 1060. The opinion hinder or delay. referenced the "pig to hog" analysis but found "especially critical to finding extrinsic evidence of an intent to hinder or delay" was that the debtor's wife carried \$ 18,000 of the proceeds in her purse rather than depositing it into the money market account at the plaintiff bank, and the homestead was paid down through a cashier's check payable to her rather than a personal check payable to the mortgage company, suggesting an effort to conceal the transactions [**37] from the plaintiff bank. [*770] Id. But on rehearing en banc, the Fifth Circuit reversed itself and affirmed the bankruptcy court's factual finding of a lack of any extrinsic evidence of intent to defraud, distinguishing Reed because the fact finder there had found such intent, and the "debtor's conduct was more egregious" than Bowyer's. 932 F.2d at 1102.

Eighth Circuit Cases Are To the Contrary

But while the Fifth Circuit decisions can be seen as consistent with the proposed analysis, the Eight Circuit decisions cannot. Norwest Bank Nebraska, N.A. v. Tveten (In re Tveten), 848 F.2d 871 (8th Cir. 1988), seems to hold that it is sufficient to deny the discharge if the amount converted into exempt assets is "too much," and Jensen v. Dietz (In re Sholdan), 217 F.3d 1006 (8th Cir. 2000), seems to hold that the discharge may be denied if the investment in exempt assets was unwise, uneconomical or unusual from the debtor's perspective.

Tveten was an affirmance of the bankruptcy court's denial of discharge after trial, so it was the lowest summarized above. Nevertheless, bankruptcy court had relied almost exclusively [**38] on the timing factors -- the debtor's knowledge of a judgment against him, his rapidly deteriorating investments, and the rapidity with which he converted nonexempt into exempt assets in 17 separate transfers shortly before bankruptcy. About the only fact mentioned that falls outside the third, timing category is that a number of the transfers were to his parents and brother, 848 F.2d at 872, which raises two flags -- the sale to a family member may be fraudulent in that it permits the debtor to retain possession or control of the asset, or may be uneconomic because of the likelihood that someone other than a family member might have paid more if the asset were adequately exposed to the market.

But one cannot read the *Tveten* opinion without concluding the majority was driven almost solely by the timing of the exemption planning and its size, almost \$700,000. And that was not only how the *Tveten* dissent read the majority's analysis, but also how the Eighth Circuit subsequently read it. In *Panuska v. Johnson* (In re Johnson), 880 F.2d 78, 82 (8th Cir. 1989), the court

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summarized the kind of extrinsic evidence of fraud necessary to deny a discharge, in terms consistent [**39] with the analysis proposed here: "further conduct intentionally designed to materially mislead or deceive creditors about the debtor's position; conveyances for less than fair value; or, the continued retention, benefit or use of property allegedly conveyed together with evidence that the conveyance was for inadequate consideration." But then it added:. "Tveten establishes that where an exemption, other than a homestead exemption, is not limited in amount, the amount of property converted into exempt forms and the form taken may be considered in determining whether fraudulent intent exists." Id. Johnson ultimately concluded that "Tveten does not apply to homestead exemptions absent traditional extrinsic evidence of fraud unrelated to the amount of money involved," and pointedly reminded "the lower courts that there is nothing fraudulent per se about making even significant use of other legal exemptions." Id. at 83. "The power sanctioned in Tveten should be reserved for exceptional cases and has no application to homestead exemptions." Id. at 84.

But then the Eighth Circuit retreated from Johnson. In Jensen, the debtor was ninety [**40] years old, afflicted with serious medical problems and living in an assisted care facility. 217 F.3d at 1010. When he was sued in a personal injury suit for an amount far in excess [*771] however, he of his insurance coverage, liquidated his bank accounts and purchased a newly built house, even though the property taxes on the house were \$ 2000 per year while the debtor was living on social security that left him with only \$ 600 per year disposable income. Id. On those facts, the Eighth Circuit upheld the bankruptcy court's finding of "ample evidence extrinsic to the mere conversion of assets that showed fraudulent intent on the part of the debtor." n21 Id. at 1010-11. The Eighth Circuit's effort to summarize that extrinsic fraudulent intent showed evidence that unenlightening:

It is one thing to convert non-exempt assets into exempt property for the express purpose of holding it as a homestead and thereby putting the property beyond the reach of creditors. (citation omitted). However, it is quite another thing to acquire title to a house for no other reason than to defraud creditors.

Id. at 1011.

n21 The objection was to the exemption, rather than to the discharge; the discharge was irrelevant because the debtor was deceased. The

bankruptcy court relied on a fraudulent conveyance analysis and utilized the badges of fraud to find the fraudulent intent, which the Eighth Circuit approved, including the reliance on the debtor's age and the value of the house. *Id. at* 1009-10 & n.5.

[**41]

The facts in Jensen well fit the second category of the badges of fraud, because the debtor's investment in the homestead was either uneconomical or an unwise investment for that particular debtor. But the Eighth Circuit's opinion fails to demonstrate how that made the intent any more fraudulent than a clear intent to convert nonexempt into exempt assets. The closest it came to such an explanation was to label the transaction "rank injustice." Id. Indeed, the inability of the Jensen opinion to explain why converting assets into exempt property for the purpose of putting it beyond the reach of creditors is one thing, but purchasing a house for no other reason than to claim a homestead exemption is another, is a good demonstration that there is no such distinction to be drawn. As the dissent noted, the facts simply showed that the debtor "sought to protect as much of his assets as the law allowed," and none of the evidence was "extrinsic to [the debtor's] act of conversion," and "therefore [is] not evidence of fraud." Id. at 1011-12 (Arnold, J., dissenting).

Conclusion

The Ninth Circuit cases discussed above may be sufficient to resolve the [**42] issue before the Court today. [HN15] Neither timing factors nor uneconomic decision-making by debtors is sufficient to deny a discharge on account of knowledgeable exemption planning. They were not sufficient to deny exemptions under the Act, and even aside from the legislative history quoted above there is no basis to conclude that Congress intended a different result under the Code, n22 and certainly not to impose an even harsher remedy, complete denial of the discharge rather than denial of a claimed exemption.

n22 See Dewsnup v. Timm, 502 U.S. 410, 419, 116 L. Ed. 2d 903, 112 S. Ct. 773 (1992) ("This Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.").

[HN16] It might also be sufficient to deny summary judgment on the basis that the requisite fraudulent intent is so individualistic and fact [**43] based that it cannot be determined without live testimony and the opportunity to judge the credibility of the debtor. See In re Chavin, 150 F.3d 726 (7th Cir. 1998).

[*772] But the analysis suggests an even stronger rule -- [HN17] unless the creditor shows a deception or concealment, an insider transaction, a fraudulent conveyance, a secretly retained possession or benefit, or debtor explanations that lack credibility, the second and third categories of badges of fraud are not sufficient to shift to the debtor the burden of going forward, even if all of the debtor's nonexempt assets were converted into exempt assets just after being sued and just before filing bankruptcy.

There are many areas of bankruptcy law where Congress apparently intended bankruptcy judges to weigh the evidence and utilize their experience and judgment to decide individual cases on a case by case basis. It does so by using terms that are inherently incapable of fine definition, such as "good faith," "substantial abuse," "undue hardship," and the like. Case law in such areas tends to identify "factors" that in reality are merely a checklist of relevant facts or issues to consider, none of which is dispositive. [**44] Perhaps such areas of bankruptcy law are best dealt with as in the civil system, with each judge reading and applying the statute and its underlying policies and principles to each factual situation that comes up, without regard to what the last judge did on different facts. Reported decisions in such areas serve little useful purpose, and in fact may be counterproductive. n23

n23 See Lawrence Ponoroff, The Dubious Role of Precedent in the Quest for First Principles in the Reform of the Bankruptcy Code: Some Lessons from the Civil Law and Realist Traditions, 74 Am. Bankr. L.J. 173 (Spring 2000).

But this is not one of those areas. [HN18] Congress did not invite bankruptcy judges to grant or deny the discharge based on an amorphous, individualistic finding such as "reasonable" or "good faith." Instead, it made the requisite determination hinge on intent, something that common law precedent has successfully refined over the centuries, particularly in tort law and in criminal law. Consequently here [**45] is it appropriate for courts to

seek to refine and define the requisite intent, so that the evolution of precedent may in the long rung yield predictable, practical rules.

And this is an area of law where that effort is particularly needed and important. As noted by the Tveten dissent, "debtors deserve more definite answers" than "each bankruptcy judge's sense of proportion." 848 F.2d at 879 (Arnold, J., dissenting). Without more definite answers, "debtors will be unable to know in advance how far the federal courts will allow them to exercise their rights under state law." Id. The result will be that some debtors who relied on well intentioned advice of counsel may be denied a discharge, the bankruptcy equivalent of the death penalty, while others receive an unconscionable benefit, perhaps through ignorance or perhaps through cunning. And as the Tveten dissent also emphasizes, for the judiciary to deny an exemption that the legislature has provided simply because the judge finds it out of proportion is to invade the province of the legislative branch. Id. at 878.

[HN19] Both the second and third categories of the badges of fraud merely underscore [**46] that the debtor intended to take advantage of available exemptions. The timing factors make that more evident than if the exempt property were purchased before bankruptcy was imminent, and engaging in an otherwise uneconomic transaction eliminates another possible motive, but neither of these makes the intent any more than an intent to utilize available exemptions. And since all authorities (except perhaps the Eighth Circuit) agree that that intent is not penalized or forbidden by [*773] § 727(a)(2)(A), that intent is not transformed into something more evil by its timing or even by the size of the transaction. Fortunately the Arizona legislature has spared both debtors and judges problems such as Tveten, by imposing dollar limits on almost all exemptions, and an additional timing limitation on the only one readily capable of substantial prebankruptcy exemption planning. n24

n24 A.R.S. § § 33-1126(A)(6) & (B).

Based on the foregoing, the Court concludes that the showing of only the timing badges of fraud is insufficient [**47] to support summary judgment for Murphey. Because Murphey has made no showing of a badge of fraud falling in the first category, Murphey's motion for summary judgment is denied.

DATED this 17th day of December, 2002.

RANDOLPH J. HAINES



Federal Trade Commission v. Affordable Media 179 F.3d 1228 (9th Cir 1999)

WIGGINS, Circuit Judge:

A husband and wife, Denyse and Michael Anderson, were involved in a telemarketing venture that offered investors the chance to participate in a project that sold such modern marvels as talking pet tags and water-filled barbells by means of late-night television. Although the promoters promised that an investment in the project would return 50 per cent in a mere 60 to 90 days, the venture in fact was a Ponzi scheme, which eventually unraveled and left thousands of investors with tremendous losses. When the Federal Trade Commission brought a complaint against the telemarketing duo, they claimed that they were simply innocent dupes rather than a modern day telephonic Bonnie and Clyde.

While the investors' money was lost in the fraudulent scheme, the Andersons' profits from their commissions remained safely tucked away across the sea in a Cook Islands trust. When the Commission brought a civil action to recover as much money as possible for the defrauded investors, the Andersons advanced two incredible propositions. First, they claimed that they should retain the 45 percent commissions they received for their role in the fraud, even though they acknowledged that the investors were defrauded. They claimed this entitlement because they merely sold the toxic investments that fueled the scheme and propped up the duplicitous house of cards. Second, the Andersons claimed that they were unable to repatriate the assets in the Cook Islands trust because they had willingly relinquished all control over the millions of dollars of commissions in order to place this money overseas in the benevolent hands of unaccountable overseers, just on the off chance that a law suit might result from their business activities. The learned district court was skeptical of both arguments and choose to grant the Commission its requested preliminary relief.

An old adage warns that a fool and his money are easily parted. This case shows that the same is not true of a district court judge and his common sense. After the Andersons refused to comply with the preliminary injunction by refusing to return their illicit proceeds, the district court found the Andersons in civil contempt of court. The Andersons appealed. We have jurisdiction under 28 U.S.C. § 1292(a)(1) and we affirm.

I

Sometime after April 1997, Denyse and Michael Anderson became involved with The Sterling Group ("Sterling"). Sterling sold such imaginative products as the "Aquabell," a waterfilled dumbbell, the "Talking Pet Tag," and a plastic wrap dispenser known as "KenKut" by means of late-night television commercials broadcast between the hours of 11:00 p.m. and 4:00 a.m. The Andersons formed Financial Growth Consultants, LLC ("Financial") to serve as the

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(Extracted from: Ayer, CBK Course Materials)

primary telemarketer of media units, an investment that afforded purchasers the opportunity to receive a portion of the profits generated from the sales of Sterling's outlandish products. Financial's telemarketers thereupon set about locating prospective investors in the media unit scheme.

The media units sold for \$5,000. Each media unit entitled the investor to participate in the sale of Sterling's products from 201 of the late-night commercials. Each product sold for \$20.00. The investor would receive \$7.50 for each product sold during his 201 commercials, up to a maximum of five products per commercial. According to Financial's telemarketers, the investors would likely receive \$37.50 per commercial (from five products sold during each commercial) for a total of \$7,537.50 - an astronomical fifty percent return in sixty to ninety days. Financial, for its part, would receive forty-five percent of the investor's \$5,000.00 investment, an amount that the Andersons assert is the industry standard.

It appears that Financial's telemarketers were especially skilled at marketing the media units. Financial may have raised at least \$13,000,000 from investors in the media-unit scheme, retaining an estimated \$6,300,000 in commissions for itself. Perhaps unsurprisingly to those not involved in the media-unit project, it turned out that Sterling could not sell enough Talking Pet Tags and Aquabells to return the promised yields to the media-unit investors. Instead, it appears that Sterling used later investors' investments to pay the promised yields to earlier investors - a classic Ponzi scheme.

On April 23, 1998, the Federal Trade Commission (the "Commission") filed a complaint in the United States District Court for the District of Nevada, charging the Andersons, Financial, and others with violations of the Federal Trade Commission Act (the "Act") and the Telemarketing Sales Rule for their participation in a scheme to telemarket fraudulent investments to consumers. Upon motion by the Commission, the district court issued an exparte temporary restraining order against the defendants. After hearings on April 30 and May 8, 1998, the district court entered a preliminary injunction against the defendants, which incorporated the provisions of the temporary restraining order. Both the temporary restraining order and the preliminary injunction required the Andersons to repatriate any assets held for their benefit outside of the United States.

In July, 1995, the Andersons had created an irrevocable trust under the law of the Cook Islands. The Andersons were named as co-trustees of the trust, together with AsiaCiti Trust Limited ("AsiaCiti"), a company licensed to conduct trustee services under Cook Islands law. Apparently, the Andersons created the trust in an effort to protect their assets from business risks and liabilities by placing the assets beyond the jurisdiction of the United States courts. As discussed more fully below, the provisions of the trust were intended to frustrate the operation of domestic courts, by removing the Andersons as trustees and preventing AsiaCiti from repatriating any of the trust assets to the United States if a so-called "event of duress" occurred.

In response to the preliminary injunction, the Andersons faxed a letter to AsiaCiti on May 12, 1998, instructing AsiaCiti to provide an accounting of the assets held in the trust and to

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repatriate the assets to the United States to be held under the control of the district court. AsiaCiti thereupon notified the Andersons that the temporary restraining order was an event of duress under the trust, removed the Andersons as co-trustees under the trust because of the event of duress, and refused to provide an accounting or repatriation of the assets. The trust assets were therefore not repatriated to the United States and the Andersons have provided only limited information to the district court and the Commission regarding the trust assets.

On May 7, 1998, the Commission moved the district court to find the Andersons in civil contempt for their failure to comply with the temporary restraining order's requirements that they submit an accounting of their foreign assets to the Commission and to repatriate all assets located abroad. At a hearing on June 4, 1998, the district court found the Andersons in civil contempt of court for failing to repatriate the trust assets to the United States and failing to provide an accounting of the trust's assets. The district court, however, continued the hearing until June 9, then until June 11, and finally until June 17, in an effort to allow the Andersons to purge themselves of their contempt. In attempting to purge themselves of their contempt, the Andersons attempted to appoint their children as trustees of the trust, but AsiaCiti removed them from acting as trustees because the event of duress was continuing. At the June 17 hearing, the district court indicated that it believed that the Andersons remained in control of the trust and rejected their assertion that compliance with the repatriation provisions of the trust was impossible. At the close of the June 17 hearing, the district judge ordered the Andersons taken into custody because they had not purged themselves of their contempt. The Andersons timely appealed the district court's issuance of the preliminary injunction and finding them in contempt. We affirm the district court.

[The court found that the district court did not abuse its discretion in granting the preliminary injunction — It also held that the need for injunctive relief was not rendered moot by virtue of the fact that the Andersons had stopped selling for Sterling.]

III

The next issue on appeal is the district court's finding the Andersons in contempt for refusing to repatriate the assets in their Cook Islands trust. . . . Based on the record before us, we find that the district court did not abuse its discretion in holding the Andersons in contempt.

The standard for finding a party in civil contempt is well settled:

The moving party has the burden of showing by clear and convincing evidence that the contemnors violated a specific and definite order of the court. The burden then shifts to the contemnors to demonstrate why they were unable to comply.

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Stone v. City and County of San Francisco, 968 F.2d 850, 856 n.9 (9th Cir. 1992) (citations omitted).

The temporary restraining order required the Andersons, in relevant part, to "transfer to the territory of the United States all funds, documents and assets in foreign countries held either: (1) by them; (2) for their benefit; or (3) under their direct or indirect control, jointly or singly." Temporary Restraining Order, entered and served April 23, 1998, at 8. These provisions were continued in the preliminary injunction. See Preliminary Injunction, entered and served May 22, 1998, at 9. It is undisputed that the Andersons are beneficiaries of an irrevocable trust established under the laws of the Cook Islands. The Andersons do not dispute that the trust assets have not been repatriated to the United States. Instead, the Andersons claim that compliance with the temporary restraining order is impossible because the trustee, in accordance with the terms of the trust, will not repatriate the trust assets to the United States.

A party's inability to comply with a judicial order constitutes a defense to a charge of civil contempt. See United States v. Rylander, 460 U.S. 752, 757, 75 L. Ed. 2d 521, 103 S. Ct. 1548 (1983) ("While the court is bound by the enforcement order, it will not be blind to evidence that compliance is now factually impossible. Where compliance is impossible, neither the moving party nor the court has any reason to proceed with the civil contempt action."). The Andersons claim that the refusal of the foreign trustee to repatriate the trust assets to the United States, which apparently was the goal of the trust, makes their compliance with the preliminary injunction impossible.

Although the Andersons assert that their "inability to comply with a judicial decree is a complete defense to a charge of civil contempt, regardless of whether the inability to comply is self-induced," Appellants' Reply Brief at 12 (emphasis added), we are not certain that the Andersons' inability to comply in this case would be a defense to a finding of contempt. It is readily apparent that the Andersons' inability to comply with the district court's repatriation order is the intended result of their own conduct - their inability to comply and the foreign trustee's refusal to comply appears to be the precise goal of the Andersons' trust.¹ The Andersons claim

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The Andersons' trust created the circumstances in which a foreign trustee would refuse to repatriate assets to the United States by means of so-called duress provisions. Under the trust agreement, an event of duress includes "the issuance of any order, decree or judgment of any court or tribunal in any part of the world which in the opinion of the protector will or may directly or indirectly, expropriate, sequester, levy, lien or in any way control, restrict or prevent the free disposal by a trustee of any monies, investments or property which may from time to time be included in or form part of this trust and any distributions therefrom." Trust Agreement at 3. Upon the happening of an event of duress, the trust agreement provides that the Andersons would be terminated as co-trustees, so that control over the trust assets would appear to be exclusively in the hands of a foreign trustee, beyond the jurisdiction of a United States court:

Notwithstanding any other provision contained in this deed any trustee hereof shall automatically cease to be a trustee upon the happening of an event of duress within the territory where such trustee is . . . resident (in the case of an individual) and upon ceasing to be a trustee pursuant to this clause such trustee shall be

that they created their trust as part of an "asset protection plan." See Appellant's Opening Brief at 36. These "so-called asset protection trusts are designed to shield wealth by moving it to a foreign jurisdiction that does not recognize U.S. judgments or other legal processes, such as asset freezes." Debra Baker, Island Castaway, ABA Journal, October 1998, at 55. The "asset protection" aspect of these foreign trusts arises from the ability of people, such as the Andersons, to frustrate and impede the United States courts by moving their assets beyond those courts' jurisdictions:

Perhaps most importantly, situs courts typically ignore United States courts' demands to repatriate trust assets to the United States. A situs court will not enforce a United States order from a state court compelling the turnover of trust assets to a creditor that was defrauded under United States law, or assets that were placed into a self-settled spendthrift trust.

James T. Lorenzetti, The Offshore Trust: A Contemporary Asset Protection Scheme, 102 Com. L. J. 138, 143-144 (1997).

Because these asset protection trusts move the trust assets beyond the jurisdiction of domestic courts, often times all that remains within the jurisdiction is the physical person of the defendant. Because the physical person of the defendant remains subject to domestic courts' jurisdictions, courts could normally utilize their contempt powers to force a defendant to return the assets to their jurisdictions. Recognizing this risk, asset protection trusts typically are designed so that a defendant can assert that compliance with a court's order to repatriate the trust assets is impossible:

Another common issue is whether the client may someday be in the awkward position of either having to repatriate assets or else be held in contempt of court. A well-drafted [asset protection trust] would, under such a circumstance, make it impossible for the client to repatriate assets held by the trust. Impossibility of performance is a complete defense to a civil contempt charge.

Barry S. Engel, Using Foreign Situs Trusts For Asset Protection Planning, 20 Est. Plan.

divested of title to the property of this trust which shall automatically vest in the remaining or continuing trustee (if any) located in a territory not having an event of duress and the form for administration of this trust shall notwithstanding any other provision in this deed be deemed to be the place of residence or incorporation (if a corporation) of such continuing trustee.

Trust Agreement at 17 (emphasis added).

For example, the trust provides the protectors with discretion to conclusively determine that an event of duress has not occurred: "For the purpose of determining whether an Event of Duress has occurred pursuant to paragraph (c) and paragraph (d) of this clause (1)(a)(vi) of this Deed, the written certificate of the Protector to that effect shall be conclusive." Trust Agreement at 3 (emphasis added).

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212, 218 (1993).

Given that these offshore trusts operate by means of frustrating domestic courts' jurisdiction, we are unsure that we would find that the Andersons' inability to comply with the district court's order is a defense to a civil contempt charge. We leave for another day the resolution of this more difficult question because we find that the Andersons have not satisfied their burden of proving that compliance with the district court's repatriation order was impossible. It is well established that a party petitioning for an adjudication that another party is in civil contempt does not have the burden of showing that the other party has the capacity to comply with the court's order. . . . Instead, the party asserting the impossibility defense must show "categorically and in detail" why he is unable to comply. . . . See also Rylander, 460 U.S. at 757 ("It is settled, however, that in raising this defense, the defendant has a burden of production.").

In the asset protection trust context, moreover, the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a characle rather than a good faith effort to comply. Foreign trusts are often designed to assist the settlor in avoiding being held in contempt of a domestic court while only feigning compliance with the court's orders:

Finally, the settlor should be aware that, although his trust will probably prove unassailable by domestic creditors, he may face minor hassles while defending his trust in court. In particular, if a creditor attacks an offshore trust in United States court, the settlor may face contempt of court orders during the proceedings. . . . There is a possibility that the court will . . . order the settlor to collect his assets from the trust and turn them over to the court. If the settlor does not comply with these orders, a court may hold him in contempt. However, there are ways around such a conflict. . . . The settlor could comply with the court order and 'order' his trustee to turn over the funds, knowing full well that the trustee will not comply with his request. Thereby, the settlor would technically comply with the court's orders, escape contempt of court charges, and still rest assured that his assets will remain protected.

James T. Lorenzetti, The Offshore Trust: A Contemporary Asset Protection Scheme, 102 Com. L. J. 138, 158 (1997). With foreign laws designed to frustrate the operation of domestic courts and foreign trustees acting in concert with domestic persons to thwart the United States courts, the domestic courts will have to be especially chary of accepting a defendant's assertions that repatriation or other compliance with a court's order concerning a foreign trust is impossible. Consequently, the burden on the defendant of proving impossibility as a defense to a contempt charge will be especially high.

Given these considerations, we cannot find that the district court clearly erred in finding that the Andersons' compliance with the repatriation order was not impossible because the Andersons remain in control of their Cook Islands trust. In finding the Andersons in civil contempt, the district court rejected the Andersons' impossibility defense, specifically finding

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that the Andersons "in the judgment of the Court [and] from the evidence that I've heard are in control of this trust." Transcript of June 17, 1998 Hearing Regarding Plaintiff's Motion for Civil Contempt, p. 30. Because we only review a district court's findings in connection with rejecting an impossibility defense for clear error, we will treat the district court's finding that the Andersons were in control of their trust as a finding of fact, subject only to the clearly erroneous standard of review. Based upon the record before us, we find that the district court's finding that compliance with the repatriation order was possible because the Andersons remain in control of their trust was not clearly erroneous.

The Andersons claim that they have "demonstrated to the district court 'categorically and in detail' that they can not comply with the repatriation section of the preliminary injunction." Appellants' Reply Brief at 13. The district court was not convinced and neither are we. While it is possible that a rational person would send millions of dollars overseas and retain absolutely no control over the assets, we share the district court's skepticism. The district court found, notwithstanding the Andersons' protestations, that

As I look at the totality of the scheme of what I see before me at this time, I have no doubt that the Andersons can if they wish to correct this problem and provide the means of putting these funds in a position that they can be accountable if the final determination of the Court is that the funds should be returned to those who made these payments.

Transcript of June 9, 1998 Hearing Regarding Plaintiff's Motion for Civil Contempt, p. 18.

We cannot say that this finding was clearly erroneous. The Andersons had previously been able to obtain in excess of \$ 1 million from the trust in order to pay their taxes. Given their ability to obtain, with ease, such large sums from the trust, we share the district court's skepticism regarding the Andersons' claim that they cannot make the trust assets subject to the court's jurisdiction.

Moreover, beyond this general skepticism concerning the Andersons' lack of control over their trust, the specifics of the Andersons' trust indicate that they retained control over the trust assets. These offshore trusts allow settlors, such as the Andersons, significant control over the trust assets by allowing the settlor to act as a cotrustee or "protector" of the trust. See Debra Baker, Island Castaway, ABA Journal, October 1998, at 56 ("Further, an offshore trust, may allow settlors to maintain significant control over their assets. Trusts can include cotrustees in the United States to watch over the actions of the foreign trustees, and settlors can name anyone, including themselves, as 'protectors' to oversee the trustees and veto their actions if necessary."). When the settlors retain this type of control, however, they can jeopardize the asset protection scheme because they will be subject to a U.S. court's personal jurisdiction and be forced to exercise their control to repatriate the assets. See id. ("If litigation is threatened, the protector and the co-trustee can resign so that no one within the personal jurisdiction of a federal or state court has control over the assets of the trust.").

The district court's finding that the Andersons were in control of their trust is well supported by the record given that the Andersons were the protectors of their trust. A protector

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has significant powers to control an offshore trust. See Gideon Rothschild, "Establishing and Drafting Offshore Asset Protection Trusts," 23 Est. Plan. 65, 70 (1996) ("The use of a trust protector or advisor is common among foreign trusts. This person . . . has the power to replace trustees and veto certain actions by the trustees."). A protector can be compelled to exercise control over a trust to repatriate assets if the protector's powers are not drafted solely as the negative powers to veto trustee decisions or if the protector's powers are not subject to the anti-duress provisions of the trust. See id. ("The protector's powers should generally be drafted as negative powers and subject to the anti-duress provisions to protect against an order compelling the protector to exercise control over the trust."). The Andersons' trust gives them affirmative powers to appoint new trustees and makes the anti-duress provisions subject to the protectors' powers,² therefore, they can force the foreign trustee to repatriate the trust assets to the United States.

Perhaps the most telling evidence of the Andersons' control over the trust was their conduct after the district court issued its temporary restraining order ordering the repatriation of the trust funds. The Andersons sent a notice to the foreign trustee, ordering it to repatriate the trust assets because the district court had issued a temporary restraining order. The foreign trustee removed the Andersons from their positions as co-trustees and refused to comply with the repatriation order. After the Andersons claimed that compliance with the repatriation provisions of the temporary restraining order was impossible, the Commission revealed to the court that the Andersons were the protectors of the trust. The Andersons immediately attempted to resign as protectors of the trust. This attempted resignation indicates that the Andersons knew that, as the protectors of the trust, they remained in control of the trust and could force the foreign trustee to repatriate the assets.³

The Andersons contend that even though they are the protectors of the trust, it is impossible for them to repatriate the trust assets. The Andersons' argument, that "there is a misstep in the FTC's logic," Appellants' Reply Brief at 17, ignores the fact that they bear the burden of proving impossibility, not the Commission. Their pointing to a few provisions of the trust, alone, is insufficient to carry their burden or to establish that the district court's finding that they remain in control of their trust was clearly erroneous.⁴

³ Although we have concentrated on the Andersons' capacity as protectors of the trust to support the district court's finding that the Andersons remain in control of the trust, we have not considered whether other facts might support the Andersons' continuing control over the trust, regardless of who is the protector of the trust. The Andersons attempted to resign their position as protectors and that attempt appears to have failed. If the Andersons have in fact resigned their position as protectors, they may still remain in control of the trust. We have not resolved this issue at this time because the Andersons have conceded that they are the protectors of the trust.

⁴ The provisions of the trust also make clear that the Andersons' position as protectors gives them control over the trust. In provisions of the trust agreement that the Andersons conveniently fail to reference, the trust agreement makes clear that the Andersons, as protectors, have the power to determine whether or not an event of duress has occurred:

Because we see no clear error in the district court's finding that the Andersons remain in control of their trust and could repatriate the trust assets, the district court did not abuse its discretion in holding them in contempt. We, therefore, affirm the district court's finding the Andersons in contempt. Given the nature of the Andersons' so-called "asset protection" trust, which was designed to frustrate the power of United States' courts to enforce judgments, there may be little else that a district court judge can do besides exercise its contempt powers to coerce people like the Andersons into removing the obstacles they placed in the way of a court. Given that the Andersons' trust is operating precisely as they intended, we are not overly sympathetic to their claims and would be hesitant to overly-restrict the district court's discretion, and thus legitimize what the Andersons have done.

"For the purpose of determining whether an Event of Duress has occurred pursuant to paragraph (c) and paragraph (d) of this clause (1)(a)(vi) of this Deed, the written certificate of the Protector to that effect shall be conclusive." Trust Agreement at 3 (emphasis added). Moreover, the very definition of an event of duress that the Andersons assert has occurred makes clear that whether or not an event of duress has occurred depends upon the opinion of the protector: "The issuance of any order, decree or judgement of any court or tribunal in any part of the world which in the opinion of the Protector will or may directly or indirectly, expropriate. . . . " Trust Agreement at 3 (emphasis added). Therefore, notwithstanding the provisions of the trust agreement that the Andersons point to, it is clear that the Andersons could have ordered the trust assets repatriated simply by certifying to the foreign trustee that in their opinion, as protectors, no event of duress had occurred.

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(Extracted from: Ayer, CBK Course Materials)

CORPORATIONS COMMITTEE BUSINESS LAW SECTION THE STATE BAR OF CALIFORNIA 180 HOWARD STREET SAN FRANCISCO, CA 94105-1639 www.calbar.org/2sec/3bus/2busndx.htm

December 16, 2002

VIA E-MAIL: rule-comments@sec.gov

Mr. Jonathan G. Katz Secretary Securities and Exchange Commission 450 Fifth Street, N.W. Washington, D.C. 20549-0609

re:

SEC File Nos. S7-45-02; 33-8150.wp Release Nos. 33-8150; 34-46868; IC-25829

Proposed Rules under Section 307 of the Sarbanes-Oxley Act of 2002 "Implementation of Standards of Professional Conduct for Attorneys"

Dear Mr. Katz:

We are writing to comment on the above-referenced release and proposal (the "Release") issued by the Securities and Exchange Commission (the "Commission") in connection with Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act"). These comments are provided on behalf of the Business Law Section of the State Bar of California (the "Business Law Section") by the Corporations Committee (the "Committee") of the Business Law Section. Please note that positions set forth in this letter are only those of the Business Law Section. As such, they have not been adopted by either the State Bar's Board of Governors, its overall membership, or the overall membership of the Business Law Section, and are not to be construed as representing the position of the State Bar of California. The Business Law Section is composed of attorneys regularly engaged in advising business enterprises in California; the Committee is composed of attorneys regularly advising California corporations and out-of-state corporations transacting business in California. Membership in the Business Law Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources. There are currently more than 16,000 members of the Business Law Section.

California is home to a significant number of issuers and securities counsel. As the largest jurisdiction in the country, California is affected perhaps more than any other state by the rules proposed in the Release to be added as new Part 205 of Title 17, Chapter II, of the Code of Federal Regulations (in the form set forth in the Release, the "Proposed Rules"; in the form ultimately adopted, the "final Rules"). This letter addresses issues arising under the Proposed Rules that we have identified as having specific conflicts with California law and the obligations

SUBMITTED BY E-MAIL

Mr. Jonathan G. Katz Secretary Securities and Exchange Commission December 16, 2002

of attorneys practicing in California. We expect the Release to draw significant comments from attorneys practicing in other jurisdictions. For purposes of better focusing our comments, we have omitted discussion of other issues arising under the Proposed Rules, such as the scope of the definition of "practicing before" the Commission, with the expectation that comments on such issues will come from other commentators.

I. SUMMARY

We believe that the Proposed Rules have many useful conceptual components which could enhance compliance by issuers with the various federal securities laws. Those may also enhance investor confidence in the integrity of public markets in the United States. Nonetheless, we have specific concerns about the Proposed Rules. Those include:

- 1. The Proposed Rules conflict with California law and the rules of conduct adopted by the California Supreme Court. This conflict is particularly acute in the case of the "noisy withdrawal" and mandatory disaffirmance requirements of the Proposed Rules (the "reporting out" provisions). In addition, we believe that the Proposed Rules may be in conflict with statutory and court rules in other jurisdictions. We recommend that the Proposed Rules avoid direct conflict with the existing California statutes and rules governing attorney conduct. We believe that the goals and purposes of Section 307 of the Act can be met -- and, in fact, will be promoted by avoiding such conflict.
- 2. The conflict between the Proposed Rules and California law is unnecessary, since it stems from a portion of the Proposed Rules (the "noisy withdrawal" and mandatory disaffirmance requirements) that departs from both the letter and spirit of the Act. The Act provides no express authority for the Commission to adopt "reporting out" or disaffirmance provisions in conflict with state laws. As a result, the conflicts between the Proposed Rules and state law requirements on attorney conduct are likely to be litigated in a variety of different fora. Protracted litigation and potentially inconsistent decisions will adversely affect investor confidence. We recommend that the Commission narrow the scope of the final Rules to eliminate the substantial uncertainties created by the text of the Proposed Rules.
- Doctrines and rules pertaining to privilege, admissibility, and duties of attorneys practicing in California are governed by California and federal law, including the securities laws. Although the Proposed Rules may purport to address these doctrines and rules, it is unclear that the Commission can impose its interpretation of them in contexts not involving the Commission. That lack of clarity will create a risk of protracted litigation and potentially inconsistent decisions.

4. The specific requirements under Section 307 of the Act that an attorney "report up" the corporate ladder on material violations of securities law establish a mechanism assuring that close or controversial legal issues are exposed to the scrutiny of independent directors. To achieve the benefits of "reporting up," however, it is not necessary — and, in fact, is harmful — to involve attorneys in "reporting out" to the Commission or the public. Such requirements are likely to impair the effective assistance of counsel, converting attorneys from advisors and advocates for their clients into quasi-regulators and judges of their clients. We do not believe that Congress intended such a fundamental realignment of responsibilities when it enacted Section 307. Further, such a change in the role of counsel undermines the purpose of Section 307, which is to promote (not discourage) access to legal advice by the proper levels of management.

The Proposed Rules contain the concept of the qualified legal compliance committee ("QLCC"), a body constituted within the issuer's Board of Directors and made up of independent directors, which will have the authority and the responsibility to investigate and take action of securities compliance questions. An attorney who reports concerns over securities law compliance to the QLCC has discharged his or her responsibilities and need not "report out." We recommend that the final Rules specify that an attorney who "reports up" to either a QLCC or the entire Board of Directors have no "reporting out" obligation under the Act and the final Rules. In that way, the specific requirements and goals of Section 307 of the Act will have been achieved, and conflicts with state law regarding attorney responsibility need not arise.

II. DISCUSSION

A. THE CONTEXT AND OBJECTIVES OF SECTION 307 OF THE ACT

The Act, which regulates a broad set of activities involving public companies, was adopted following months of scandal in which previously undisclosed financial problems with public issuers came to light. News reports and attorney work-product made public in those matters appear to contain examples of executives who (i) were uninformed of the existence or potential consequences of critical activities and practices within the company, (ii) used such lack of awareness as a defense to allegations of their own misconduct, or (iii) both. According to the Release, the amendment offered to pending legislation which ultimately became Section 307 of the Act was a direct result of Senator Edwards' concern that improper — and generally overly limited — use of legal advice had contributed to executives pleading ignorance of material problems and legal obligations.

The "reporting up" provisions in Section 307 of the Act address such failures directly by mandating that, in connection with preparing rules on the "minimum standards" for professional conduct before the Commission, the Commission include a rule requiring an attorney to report evidence of material legal issues up the chain of command in an issuer.

Fulfillment of these "reporting up" provisions under the Act would significantly diminish any reasonable basis for management to assert ignorance of legal issues or the consequences of controversial actions, by bringing increased scrutiny to controversial or close legal decisions. Management personnel (and attorneys) who know they must justify a controversial recommendation or decision to, and gain the agreement of, a company's independent directors may well decide against advancing narrow, technical interpretations of the law that promote management self-interest but not necessarily the best interests of the corporation.

Where the Proposed Rules address and promote the receipt by the appropriate levels of management -- up to and including the board of directors -- of legal advice, we believe the Proposed Rules promote the purposes of the Act and the securities laws generally. And they contribute to increased compliance with the law. The "reporting out" provisions, however, by discouraging corporate insiders from seeking advice in the first place, undermine this goal. Frankly, by eliminating a "reporting out" obligation if a QLCC is formed, the Commission has acknowledged that the "reporting out" obligation is not necessary to carry out the intent of Section 307. Without commenting on whether or not QLCCs should be encouraged, we believe that an attorney's ethical duties should not turn on whether or not a report is made to the full board (including independent directors) or to a QLCC.

B. CONGRESS INTENDED LIMITED SCOPE FOR SECTION 307 OF THE ACT

Section 307 of the Act does not give the Commission the authority to pre-empt state laws relating to attorney-client confidences, withdrawals, or waivers of privilege. The text of Section 307 of the Act does not support the Proposed Rule's requirements of noisy withdrawal and disaffirmance. Beyond the specific "reporting up" requirements, Section 307 of the Act directed the Commission to:

"issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission."

The legislative history of the Act reinforces that it should be read in a limited fashion. As the Commission noted at footnote 57 to the Release, Senator Enzi stated in the debate over Section 307 that it "would not require attorneys to report violations to the SEC." (emphasis added) An expanded report of Senator Enzi's remarks makes the limited intent of Section 307 even more plain:

"The amendment I am supporting would not require the attorneys to report violations to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors.



"Some argue that the amendment will cause a breach of client/attorney privilege, which is ludicrous. The attorney owes a duty to its client which is the corporation and the shareholders. By reporting a legal violation to management and then the board of directors, no breach of the privilege occurs, because it is all internal-within the corporation and not to an outside party, such as the SEC [emphasis added].

"This amendment also does not empower the SEC to cause attorneys to breach their attorney/client privilege. Instead, as is the case now, attorneys and clients can assert this privilege in court."

148 Cong. Rec. S6555. See also comments of Senator Corzine at 148 Cong. Rec S6556.

In other words, Congress wanted to have attorneys obligated to "report up," but not to "report out," as the noisy withdrawal and disaffirmance elements of the Proposed Rules would require. Congress certainly knew how to require "reporting out" had they wanted to: Section 10A of the Securities Exchange Act of 1934, as amended, requires such reporting out by accountants. Congress knew, however, that the role of counsel differs profoundly from that of an accountant, and therefore consciously stopped short of limiting in any way the traditional confidentiality that has marked the relationship between attorney and client. The Commission itself noted in the Release that "[p]roviding notification to the Commission, however, goes beyond what the Act expressly directed the Commission to do." Worse, it does just what the sponsors of Section 307 said it would not do.

We recognize that the Commission staff asserts the power to preempt state law relating to matters covered by the Proposed Rules. We also note, however, that the Supreme Court has repeatedly held that the intent to preempt state law must be clearly manifested by Congress. See, Reid v. Colorado, 187 US 137, 148 (1902); Sprietsma v. Mercury Marine, 2002 US Lexis 9067, at *32 (decided December 3, 2002). Both the language of Section 307 and the legislative history of the Act demonstrate that, whatever one thinks of the wisdom of the Commission's "noisy withdrawal" and disaffirmance proposals, Congress has hardly expressed a manifest intent to preempt contrary state rules, such as those of our State. We note further that any claimed preemption of state laws is likely to be challenged and it may be some years before the question is finally resolved. The resulting uncertainty would not operate "in the public interest" or "for the protection of investors."

This issue is of acute interest to California business attorneys. As noted in Section II.C. below, California attorneys would be prohibited in most cases from complying with the "noisy withdrawal" component of the Proposed Rules as well as further portions of the Proposed Rules requiring disclosure to anyone other than the client itself. California attorneys could well find themselves obligated to challenge the Proposed Rules if they are ultimately adopted in their current form.

5

C. THE PROPOSED RULES CONFLICT WITH CALIFORNIA ATTORNEYS' ETHICAL REQUIREMENTS

Under Section 205.3(d)(i)(A) and (B) of proposed Rule 205, an attorney retained by the issuer who did not receive, within a reasonable time, an appropriate response to a report of evidence of a material violation, would (if the attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors) be obligated not only to withdraw from representing the issuer, but also to notify the Commission in writing both of the withdrawal and the fact that such withdrawal is based on professional considerations. Under Section 205.3(d)(1)(i)(C), the attorney would also be required to disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document "that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading ..."

Were the Commission's proposals on noisy withdrawal and disaffirmance adopted, California counsel would be put in an untenable situation in those circumstances where they were called upon to comply with the withdrawal and disaffirmance mandates of Section 205.3(d). Members of the California bar are subject to the Rules of Professional Conduct of the State Bar of California, adopted by the State Bar's Board of Governors and approved by the California Supreme Court, and to the State Bar Act, Cal. Business & Professions Code § 6000 et seq. California's "reporting up" requirement is found in Rule of Professional Conduct 3-600 ("Rule 3-600"), discussing a member's responsibilities when representing "an organization." The relevant portion of Rule 3-600 provides:

- "(B) If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, the member shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code section 6068, subdivision (e). Subject to Business and Professions Code section 6068, subdivision (e), the member may take such actions as appear to the member to be in the best lawful interest of the organization. Such actions may include among others:
- "(1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or

- "(2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.
- "(C) If, despite the member's actions in accordance with paragraph (B), the highest authority that can act on behalf of the organization insists upon action or a refusal to act that is a violation of law and is likely to result in substantial injury to the organization, the member's response is limited to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700 [emphasis added]."

While Rule 3-700 permits -- and in certain circumstances requires -- counsel to withdraw from employment under certain circumstances, including if a client "seeks to pursue an illegal course of conduct," it stipulates that a member "shall not withdraw from employment until the member has taken reasonable steps to avoid reasonably foreseeable prejudice to the rights of the client" In any event, the member's response is limited to withdrawal.

The general duties of California counsel are set forth in Section 6068 of the California Business and Professions Code. Section 6068(e) provides:

"It is the duty of an attorney to do all of the following: [...] (e) To maintain inviolate the confidence and at every peril to himself or herself to preserve the secrets, of his or her client."

Section 6068(e)'s admonition to counsel to maintain "at every peril to himself or herself" the confidences of counsel's client is symbolic of California's tradition of strictly and zealously protecting the attorney-client privilege. As observed by our Supreme Court, "[w]hile it is perhaps somewhat of a hyperbole to refer to the attorney-client privilege as 'sacred,' it is clearly one which our judicial system has carefully safeguarded with only a few specific exceptions." Mitchell v. Superior Court, 37 Cal. 3d 591, 600, 208 Cal. Rptr. 886 (1984) (footnote omitted). In California, the privilege extends even to prohibiting a trial court from examining documents in camera to determine whether the privilege adheres to the document. Evidence Code § 915; Southern California Gas Co. v. Public Utilities Commission, 50 Cal. 3d 31, 45 n. 19, 265 Cal. Rptr. 801 (1990).

D. CREATING CONSISTENT AND CLEAR DUTIES FOR ISSUERS AND ATTORNEYS

The "reporting up" requirements of Section 307 of the Act are consistent with the ethical obligations of attorneys under California Rule 3-600. An attorney's obligations under Rule 3-600 may arise in the context of the attorney acting either as an advisor or as an advocate. In each case, the attorney owes professional duties to the client, but the decision making authority with regard to the action the client takes after receiving the attorney's advice

resides with the client, as does the responsibility to make such decisions. The attorney is not permitted to disclose client confidences without the client's consent, as contemplated by the Proposed Rules, other than in extraordinary circumstances much narrower than the scope of the Proposed Rules and only as expressly permitted by California law.

The obligation to comply with the securities laws resides with the issuer. The text of Section 307 of the Act does not suggest that attorneys should become guarantors of their clients' securities law compliance, nor, as noted above, did Congress so intend. Section 307 does specifically intend that the highest levels of the issuer, if necessary, receive legal advice concerning what counsel believes to be a material violation of the securities laws, as part of the issuer's decision making process in complying with the securities laws. Once counsel has provided advice regarding the nature and extent of the issuer's securities laws duties, the ultimate obligation to comply with the securities laws continues to reside with the issuer.

The Commission staff developed, for purposes of the Proposed Rules, the concept of the QLCC, which would consist of independent members of the Board of Directors having the obligation and the authority to make securities law compliance investigations and decisions on behalf of an issuer. Under the Proposed Rules, an issuer that has constituted a QLCC will have full responsibility for matters referred to it by counsel; an attorney who has made a referral under Rule 205.3(c)(1) has no obligation to make a noisy withdrawal or disaffirm the issuer's filings.

The decisions and actions by the issuer concerning securities law compliance in the circumstances set out in Rule 205.3(c)(1) are the issuer's alone. This model (attorney advises, client decides and acts) is consistent with the text of Section 307 and attorneys' obligations under state law, and should be adopted as the basic model for all issuer and attorney relations in the final version of the rules under Section 307. It provides certainty to issuers and counsel concerning their respective duties, and fulfills the objectives of Section 307.

III. DISCUSSION OF SPECIFIC ELEMENTS OF PROPOSED RULES

A. IDENTITY OF CLIENT

Under California law, an attorney who represents a corporation represents the entity, but does not thereby also represent the shareholders. This distinction is set out in Rule 3-600(A), (D) and (E), and was confirmed in *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Superior Court*, 60 Cal. App. 4th 248, 254-255, 70 Cal. Rptr. 2d 419 (4th Dist. 1997) (under Rule 3-600 the client is the corporation, not its shareholders, acknowledging that the interest of the corporation, as counsel's client, can be adverse to those of its shareholders); *National Football League Properties, Inc. v. Superior Court*, 65 Cal. App. 4th 100, 107-108, 75 Cal. Rptr. 2d 895 (6th Dist. 1998) (attorney representing corporation does not become the representative of its shareholders); *Skarbrevik v. Cohen, England & Whitfield*, 231 Cal. App. 3d 692, 703-704, 282 Cal. Rptr. 627 (2d Dist. 1991).

We are concerned that Rule 205.3(a)'s reference to "act in the best interests of the issuer and its shareholders" is inconsistent with California law. The board of directors, as a matter of corporate law, is obligated to act in the best interests of the corporation and its shareholders. California Corporations Code §309(a). An attorney who disagreed with the board's decisions regarding the best interests of shareholders should not be authorized by Rule 205.3(a) to act on his or her own judgment in place of the client's -- i.e., the board's -- directions. Moreover, the laws of many states extend fiduciary duties of directors in certain instances to take into account the interests of other constituencies, such as creditors. We do not believe Congress intended the Proposed Rules to override the substantive provisions of the law of California or other states as to the identity and nature of the client. As a result, we believe that the words "and its shareholders" should be dropped from Proposed Rule 205.3(a).

B. "REPORTING UP" AND "REPORTING OUT"

1. "Reporting Out" Inhibits Effective Legal Counsel

A significant objective of the "reporting up" elements of the Act was to bring increased scrutiny to controversial or close legal decisions. The Act achieves a very significant improvement in corporate governance by creating a structure in which executives and management of issuers will find it difficult, if not impossible, to keep their heads in the sand with respect to activities of their company or to foster an environment in which subordinates are encouraged or even expected to do likewise.

We believe, however, that the "reporting out" mechanisms established in the Proposed Rules could well put attorneys in the position of essentially being accusers of, rather than advisors to, clients. For that reason, the client may very well find it safer to avoid consulting counsel on close or controversial legal questions -- precisely the ones for which legal counsel can be most critical. Fundamental to the right to counsel is the right to effective legal counsel. In order to achieve that, courts have concluded that clients must not have the built-in disincentive of candor and openness with legal counsel potentially being used against the client.

Yet that is exactly what the Proposed Rules would accomplish. In that context, they are virtually certain to inhibit the effective provision of legal advice and counsel, which, by definition, will diminish the amount of information available to issuers by which they can assure compliance with the law.

2. Conforming OLCC and Non-OLCC Reporting

We are somewhat concerned about constituting a QLCC as a separate committee. Where economic competitiveness requires corporations to be more and more efficient at all

levels (operations and management), imposing another level of bureaucratic structure could be counterproductive. As a practical matter, more and more public companies are finding it very difficult even to identify and recruit qualified persons to serve as members of the Board of Directors and who are in fact independent of the management and the corporation itself.

We do see a benefit to having a body constituted within the corporate structure to serve as the ultimate authority on, and have ultimate responsibility for, securities compliance matters. And if the Commission insisted on adopting "noisy withdrawal" and dissafirmance rules at odds with California law, the QLCC proposal would help attorneys licensed to practice law in the State of California discharge their responsibilities under the Rules of Professional Conduct, assuming their clients chose to create such a committee since, as we understand it under the Proposed Rules, referring a matter to the QLLC eliminates any requirement for a "noisy withdrawal."

We believe, however, that the Proposed Rules should not distinguish between what would otherwise be seen as both normal and fully-compliant "reporting up" reporting for issuers which have a QLCC and those which do not. An attorney who brings a matter up-the-ladder to the entire Board should fully discharge his or her responsibilities under the Proposed Rules by doing so. Among other things, the independent members of that body certainly have the tools at that point to determine whether or not they wish to continue service in that capacity should the client fail to heed the advice of the attorneys. Once independent directors (or the entire Board) have been fully briefed regarding what the company's counsel has determined to be a material legal issue, the obligations of directors under state corporation law and under state and federal securities laws should provide — and traditionally have provided — adequate protection for the interests of investors. Moreover, that is achieved without conflicts which would result from exposing legal counsel to conflicting obligations under the Proposed Rules and state laws relating to client confidences.

3. "Noisy Withdrawal"

We believe the final version of the Proposed Rules should not include the concept of "noisy withdrawal". As noted above (see Section II.C.), the obligation for an attorney to provide the notice specified in proposed Section 205.3(d) presents conflict with the obligations imposed upon attorneys subject to California's ethical standards. As also noted above, that will inevitably result in litigation and the uncertainty which accompanies it. It is also completely unnecessary in accomplishing the goal of Section 307.

4. Disaffirmance

For the reasons just given, we believe the final version of the Proposed Rules should not include the concept of mandatory disaffirmance of filings when counsel has fulfilled

the "reporting up" requirements. Apart from issues relating to breaches of client confidences, the concept of "disaffirming" actual documents (or portions thereof) filed or submitted to the Commission or incorporated therein by reference also presents a problem of disclosure of client confidences without client consent.

5. Waiver

Despite the text in the Proposed Rules at Rule 205.3(e) that certain disclosures will not constitute a breach of the attorney-client privilege and/or fiduciary duties owed to a client, such privileges and duties are created by state law jurisdictions. Whatever effect such provision of the Proposed Rules would have, it will be relevant only in the context of the proceedings with the Commission. Other tribunals and authorities will judge for themselves the effect outside of such proceedings. Moreover, assurances of the Commission in the Proposed Rules notwithstanding, attorneys are unlikely to take the chance that a communication by an attorney under the Proposed Rules does not constitute a waiver absent litigation and a final court determination to that effect.

By its nature, a waiver is a black or white matter. If the privilege is waived in one context, it may be deemed waived in all other contexts including those which are completely unrelated to the one in which the communication occurred. As a result, the issue of waiver is most likely to come up in the context of a suit not involving the Commission at all and not in the federal courts. When that occurs, the conduct of the attorney is certainly going to be scrutinized against the requirements of state law. The chances for inconsistent results are significant. None of that achieves the goals and purposes of Section 307 of the Act. In contrast, doing so is certain to invite controversy and litigation of a prolonged nature.

C. MANDATED DOCUMENTATION

At various stages in the process of "reporting up" the Proposed Rules impose an obligation on the attorney to prepare what would effectively be called a "memorandum to the file." In many instances, an attorney may want to do that simply to preserve for the client and its counsel a record of deliberations. On the other hand, in some circumstances that may in fact not be consistent with the interests of the client and for that reason may be inappropriate. That determination is itself a matter of law and it would not be proper for the Commission to arrogate to itself the role of making that determination as de facto legal counsel to the issuer.

The purpose of the requirement is not at all clear from the Release or the Proposed Rules. By way of example, we recognize there may be some belief that preparation of such documents will by their nature be "outside the scope of employment" and as a result would not constitute to "attorney-work product." That could focus the inquiry on whether those documents were subject to compulsory discovery. We believe that any such assertion would



almost certainly be incorrect. In any event, we are quite confident in predicting that any such assertion would be met with significant and prolonged legal challenges.

It is also important to note that the process as envisioned in the Proposed Rules would occur at exactly the time when there was disagreement between an attorney and the client. At the very least, requiring the attorney to produce such product by virtue of his or her separate obligation to the Commission is bound to present potential for conflict of interest.

IV. PROPOSALS

For the reasons discussed above, we propose that the Commission make the following changes to the Proposed Rules prior to adopting them in final form:

1. Discharge of Counsel's Duty, and "Noisy Withdrawal"

We have noted above that there are conflicts between a California attorney's state law obligations to clients and the obligations established by the Proposed Rules. We believe that the existence of such conflicts will lead to challenges of the Proposed Rules, if they are adopted in their current form. We have noted that the specific "reporting up" requirements of Section 307 of the Act are directed at achieving legal disclosure at the highest independent level of decision making within an issuer, permitting those persons bound by fiduciary duties as directors to decide securities compliance issues. We have noted that the QLCC structure developed in the Proposed Rules includes the concept that a complete "reporting up" to the QLCC discharges the attorney's duties and no noisy withdrawal or disaffirmance of client fillings is required.

To achieve certainty for both issuers and their counsel, the Proposed Rules, in their final form, should include the concept that an attorney has discharged his or her duties under Rule 205 by "reporting up" to either the QLCC or the entire board, and that no mandatory disaffirmance or noisy withdrawal obligations be imposed.

2. Waiver

The language at Rule 205.3(e)(3) should be withdrawn.

3. Disaffirmance

The language at Rule 205.3(d) relating to disaffirmance should be amended to withdraw references to mandatory disaffirmance.

SUBMITTED BY E-MAIL

Mr. Jonathan G. Katz Secretary Securities and Exchange Commission December 16, 2002

4. Identity of Client

The words "and its shareholders" should be withdrawn from Rule 205.3(a).

We hope the foregoing is useful to the Commission and Staff in considering appropriate modifications to the proposed Rules under Section 307 of the Sarbanes-Oxley Act of

286 B.R. 412

40 Bankr.Ct.Dec. 147 (Cite as: 286 B.R. 412)

United States Bankruptcy Court, C.D. California.

In re WHEATFIELD BUSINESS PARK LLC. Debtor.

Nos. LA 02-21691-SB, LA 02-21693-SB, LA 02-22988-SB.

Nov. 22, 2002.

Related Chapter 11 debtors moved for appointment of law firm as their counsel. The Bankruptcy Court, Samuel L. Bufford, J., held that: (1) while there is presumption against employment of single attorney or law firm to represent related entities that have filed Chapter 11 petitions, prospective counsel may seek to rebut this presumption on appropriate notice; and (2) notice had to be given to all creditors, before bankruptcy court could allow same law firm to represent related debtors with potential claims against each other.

So ordered.

West Headnotes

[1] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Bankruptcy statute authorizing trustee to employ professionals who are disinterested, and who do not hold or represent any interest adverse to estate, is rooted in Congressional intention of holding professionals who perform duties for estate to strict fiduciary standards. Bankr.Code, 11 U.S.C.A. § 327(a).

121 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Main policy behind bankruptcy statute authorizing trustee to employ professionals who are disinterested, and who do not hold or represent any interest adverse to estate, is to ensure that any professional employed in case will devote his or her undivided loyalty to client. Bankr.Code, 11 U.S.C.A. § 327(a).

131 Attorney and Client 21.5(6) 45k21.5(6) Most Cited Cases

Debtor's counsel must be able to act in best interests

of estate, free of any prior or ongoing commitments. Bankr.Code, 11 U.S.C.A. § 327(a).

[4] Bankruptcy 3030 51k3030 Most Cited Cases

Chapter 11 debtor does not have absolute right to counsel of its choice. Bankr.Code, 11 U.S.C.A. § 327(a).

151 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Statutory limitations on what professionals are eligible for employment by trustee also applies to professionals employed by Chapter 11 debtor-in-possession. Bankr.Code, 11 U.S.C.A. § 327(a).

161 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

To be eligible for employment by trustee or Chapter 11 debtor-in-possession, professional (1) must not hold or represent any interest adverse to estate, and (2) must be disinterested person. Bankr.Code, 11 U.S.C.A. § 327(a).

17] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

If there is any doubt as to existence of conflict, such as would disqualify professional from employment by estate, that doubt should be resolved in favor of disqualification. Bankr.Code, 11 U.S.C.A. § 327(a).

181 Attorney and Client 21.5(6) 45k21.5(6) Most Cited Cases

Where bankruptcy debtor is creditor of related debtor, it is presumptively improper for same attorney, or law firm, to act as general counsel for both of these related debtors. Bankr.Code, 11 U.S.C.A. § 327(a).

19] Bankruptcy 3155 51k3155 Most Cited Cases

191 Bankruptcy 3179 51k3179 Most Cited Cases

Bankruptcy Rule imposing certain disclosure obligations upon professionals seeking employment is to assure that both the court and parties in interest receive full disclosure of all actual or potential

conflicts that might affect professional's representation of trustee, committee or debtor-in-possession. Fed.Rules Bankr.Proc.Rule 2014, 11 U.S.C.A.

[10] Bankruptcy 3155 51k3155 Most Cited Cases

10 Bankruptcy 3179
51k3179 Most Cited Cases

Bankruptcy Rule requires that any professional seeking employment by estate must disclose affirmatively all actual and potential conflicts of interest which may be relevant to determining whether he or she meets statutory requirements. Bankr.Code, 11 U.S.C.A. § 327(a); Fed.Rules Bankr.Proc.Rule 2014, 11 U.S.C.A.

111 Attorney and Client 21.10 45k21.10 Most Cited Cases

Under California law, consent is required before attorney will be allowed to represent actual conflicting interests or potentially conflicting interests.

12 Attorney and Client 21.5(6) 45k21.5(6) Most Cited Cases

Where neither the bankruptcy statute governing employment of professional persons nor related Bankruptcy Rule defined what constituted a disqualifying conflict of interest, bankruptcy court would look to California law to determine whether law firm which Chapter 11 debtors sought top employ was eligible for such employment. Bankr.Code, 11 U.S.C.A. § 327(a).

13 Attorney and Client 21.5(6)
45k21.5(6) Most Cited Cases

[13] Bankruptcy € 3029.1 51k3029.1 Most Cited Cases

Attorney (or other professional) may not represent debtor in Chapter 11 case if attorney has or represents actual conflicting interest; prohibition is absolute, and is not subject to waiver or consent. Bankr.Code, 11 U.S.C.A. § 327(a).

14 Attorney and Client 21.5(6)
45k21.5(6) Most Cited Cases

Attorney may not represent Chapter 11 debtor, where attorney holds or represents a potential conflicting interest that is of such a level as to create meaningful incentive for attorney to act contrary to best interests of estate and its various creditors. Bankr.Code, 11 U.S.C.A. § 327(a).

15 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

While actual conflict of interest is disqualifying per se, potential conflict of interest may also require disqualification of professional where, in judgment of court, it is sufficiently important and there is sufficient likelihood that it will ripen into actual conflict. Bankr.Code, 11 U.S.C.A. § 327(a).

116 Attorney and Client 21.5(6) 45k21.5(6) Most Cited Cases

Naked existence of potential for conflict of interest does not disqualify professional from employment by bankruptcy estate; rather it is for court to decide whether attorney's proposed interest carries with it sufficient threat of material adversity to warrant disqualification. Bankr.Code, 11 U.S.C.A. § 327(a).

19 Attorney and Client 45k19 Most Cited Cases

There is nothing in bankruptcy statute that governs employment of professionals to prevent attorney from representing estate merely because that representation may create appearance of impropriety. Bankr.Code, 11 U.S.C.A. § 327(a).

18 Attorney and Client 21.20 45k21.20 Most Cited Cases

While there is presumption against employment of single attorney or law firm to represent related entities that have filed Chapter 11 petitions, prospective counsel may seek to rebut this presumption at hearing upon notice to all creditors in each of related cases; notice must be sufficient to inform all creditors that employment may result in conflicts of interest and lack of adequate representation of interests of respective bodies of creditors. Bankr.Code, 11 U.S.C.A. § 327(a).

191 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

In certain circumstances, potential conflict of interest

may be waived, so as to permit professional's employment by trustee or Chapter 11 debtor. Bankr.Code, 11 U.S.C.A. § 327(a).

[20] Attorney and Client 21.5(6) 45k21.5(6) Most Cited Cases

Whether it is appropriate, despite the presumption to the contrary, to allow single attorney or law firm to represent related Chapter 11 debtors turns upon facts of particular case. Bankr.Code, 11 U.S.C.A. § 327(a).

[21] Attorney and Client 21.10 45k21.10 Most Cited Cases

Waiver or consent to attorney's representation of potentially conflicting interests is not available in bankruptcy to the same degree as in non-bankruptcy cases. Bankr.Code, 11 U.S.C.A. § 327(a).

[22] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Whether professional is disqualified by potential conflict of interest from representing estate must be determined on case-by-case basis. Bankr.Code, 11 U.S.C.A. § 327(a).

123 Attorney and Client € 21.20 45k21.20 Most Cited Cases

Before bankruptcy court can determine whether to permit single attorney or law firm to represent related debtors, creditors must be notified and given opportunity to be heard by means of notice sufficient to provide adequate information to creditors of proposed joint representation and known potential conflicts of interest. Bankr.Code, 11 U.S.C.A. § 327(a).

[24] Attorney and Client € 21.10 45k21.10 Most Cited Cases

Related Chapter 11 debtors that law firm sought to represent, each of which, under cross-collateralization provision in their loans, had potential claims against the other, could not waive potential conflicts by signing waiver; rather, decision whether to waive conflict was for creditors to make after appropriate notice. Bankr.Code, 11 U.S.C.A. § 327(a).

[25] Attorney and Client 21.10

45k21.10 Most Cited Cases

In some cases, notice to all creditors may be required in order for court to allow same attorney or law firm to represent related Chapter 11 debtors upon theory that any conflict has been waived; however, in other cases, notice to committee of creditors, to principal creditors, and to other creditors that have requested special notice may suffice. Bankr.Code, 11 U.S.C.A. § 327(a).

1261 Attorney and Client 21.10 45k21.10 Most Cited Cases

In deciding what notice had to be provided to creditors to enable court to approve law firm's representation of multiple, related corporate debtors on express waiver of conflict theory, court had to consider size of creditor body, nature of potential conflicts at issue and any other relevant circumstances. Bankr.Code, 11 U.S.C.A. § 327(a).

127 Attorney and Client 21.10 45k21.10 Most Cited Cases

All creditors had to first be given appropriate notice, before bankruptcy court could allow same law firm to represent related Chapter 11 debtors with potential claims against each other, where number of creditors in each case was relatively small, so that there was no substantial burden in giving appropriate notice to all creditors, and potential conflicts were sufficiently weighty. Bankr.Code, 11 U.S.C.A. § 327(a).

*415 Michael H. Weiss, Berkowitz, Black & Zolke, Beverly Hills, CA, for debtor.

John A. Graham, Bethann R. Young, Jeffer, Mangels, Butler & Marmaro, Los Angeles, CA, for The Capital Company of America LLC.

Russell Clemeson, Assistant United States Trustee.

First Amended Opinion on Notice re Conflicts of Interest in Employment of Counsel

SAMUEL L. BUFFORD, Bankruptcy Judge.

I. INTRODUCTION

The three debtors in these administratively consolidated cases have moved for the appointment of Berkowitz, Black & Zolke and its predecessor

Weiss & Spees, LLP (collectively "BBZ") as counsel for each of them. Because employment in all three cases poses several potential conflicts of interest, consent of the relevant parties must be obtained. For a debtor in a bankruptcy case, which is presumptively insolvent, such consent must be obtained from the creditors. The court finds that, despite the lack of explicit provision in *416 § 327(a) [FN1] authorizing consent to the representation of potentially conflicting interests resulting from the representation of related chapter 11 debtors, such consent can be effectively given in appropriate Actual conflicts of interest, in circumstances. contrast, cannot be authorized. The court further finds that the failure to object, after appropriate notice and opportunity to be heard, constitutes consent to the employment under § 327.

FN1. Unless otherwise indicated, all chapter, section and rule references are to the Bankruptcy Code, 11 U.S.C. § § 101-1330 (West 2002) and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9036 (West 2002).

The court holds that consent of the creditors is given if the creditors do not object after they are given notice and an opportunity to be heard. However, in these cases the court lacks evidence that sufficient notice of the application, including notice of possible conflicts of interest, has been given to the creditors. Accordingly, the court cannot act on the employment application until it receives evidence that such notice has been given.

II. RELEVANT FACTS

Wheatfield Business Park, LLC ("Wheatfield"), ("Hebron"), and Hebron Business Park, LLC Poughkeepsie Business Park, LLC ("Poughkeepsie") are chapter 11 debtors in these procedurally consolidated cases. The sole asset of each debtor is a warehouse and light industrial business complex. Wheatfield's property is located in Wheatfield, New Poughkeepsie's property is York (near Buffalo). located in Poughkeepsie, New York. Hebron's property is located in Hebron, Ohio, some 30 miles east of Columbus. Each debtor is a limited liability corporation, and is part of a business group that includes collective parent business entities and numerous other entities that are not in bankruptcy. The managing member of each debtor is Industrial Realty Group, Inc. ("IRG"), which also owns one percent of each debtor.

In addition to collective business parents, the debtors have also engaged in business transactions between themselves that raise potential conflicts of interest. It remains to be determined whether these transactions must be investigated as part of the bankruptcy process.

The relationship between Capital Corporation of America ("CCA") and these debtors arose from a common plan to acquire and develop the properties involved in these cases as well as other properties. The business plan of Stuart Lichter, the principal behind these debtors and a number of other business entities, was to acquire distressed commercial properties with substantial vacancies, to rehabilitate the properties, and to lease them to new tenants. To finance the acquisitions, Lichter obtained a credit line from CCA's predecessor, which was amended from time to time. The general terms were that CCA would fund up to 100% of the purchase price of any single property, provided that its overall lending exposure was limited to 85% of the collective value of the properties. The parties contemplated that each property would be owned by a separate business entity, and a portion of the overall outstanding loan would be allocated to each. There was no requirement that each property would have at least 15% excess value--only that the entire enterprise would meet this test. The loans were crosscollateralized by the various entities to protect CCA's interest in this overall ratio.

Pursuant to this plan, Lichter acquired approximately a dozen properties and proceeded to develop them. The debt was *417 refinanced and reallocated among the various business entities several times during the course of the business. In due course, most of the properties were refinanced separately or sold, and the CCA indebtedness was paid down. Eventually, only the three properties remained that are involved in these chapter 11 cases. However, because of the recent downturn in the economy and in industrial property values, the overall 15% equity cushion has eroded.

IRG retained BBZ on behalf of the debtors, and agreed that IRG would guaranty the debtors' legal fees and costs. The retention agreement did not purport to create an attorney-client relationship between IRG and BBZ. In addition, IRG acknowledged the possibility that its interests may be adverse to the debtors and agreed to retain separate counsel as to any such matters. Each debtor has

given its consent to the joint representation in this case.

Each debtor has applied for the appointment of BBZ as its counsel in each of the three cases. The applications include a disclosure of potential conflicts of interest. BBZ also discloses that IRG paid the firm a retainer of \$25,830 on behalf of each debtor.

BBZ has given separate notice to the creditors in each case that it seeks employment in that case. However, there is no evidence that the creditors have been given notice of any of the potential conflicts of interest that have emerged. Indeed, there is no evidence before the court that the creditors have even been notified that the other related debtors have applied for the appointment of BBZ in their cases as well.

CCA objected to debtors' motion to employ BBZ. However, pursuant to a settlement between the debtors and CCA, it has withdrawn its objections.

III. DISCUSSION A. Governing Law

The employment of counsel in a bankruptcy case is governed by § 327, Rule 2014, and the applicable rules of professional conduct.

The legal regime governing bankruptcy cases is a mixture of federal and state law. Federal bankruptcy law determines some rights of the parties. Where bankruptcy law does not govern, the underlying non-bankruptcy law (usually state law) determines the rights of the parties. See, e.g., In re Plitt Amusement Co. of Washington, Inc., 233 B.R. 837, 840-41 (Bankr.C.D.Cal.1999); cf. Butner v. United States, 440 U.S. 48, 54-55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (holding that property interests are created and defined by state law; unless some federal interest requires a different result, there is no reason why such interest should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding).

1. Section 327(a)

Section 327(a) specifies the qualification standards for professionals, including attorneys, who are employed in a bankruptcy case. This statute provides:

[T]he trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

[1][2][3][4] Section 327 is rooted in the "congressional intention to hold professionals performing duties for the estate to strict fiduciary standards." See, e.g., In re Envirodyne Indus., Inc., 150 B.R. 1008, 1016 (Bankr.N.D.III.1993). The section's main policy objective is to assure that a professional *418 employed in the case will devote undivided loyalty to the client. See In re Lee, 94 B.R. "Conflicting 172, 178 (Bankr.C.D.Cal.1988). loyalties produce inadequate representation, which threatens the interests of both the debtor and the creditors, and compromises the ability of the court to mete out justice in the case." Id. Furthermore, "what may be acceptable in a commercial setting, where all of the entities are solvent and creditors are being paid, is not acceptable when those entities are insolvent and there are concerns about intercompany transfers and the preference of one entity and its creditors at ... the expense of another." Envirodyne. 150 B.R. at 1018; see also In re Amdura Corp., 121 B.R. 862, 866 (Bankr.D.Colo.1990). counsel must be able to act in the best interests of the bankruptcy estate, free of any prior or ongoing Envirodyne, 150 B.R. at 1018. commitments. "Because of these limitations, a chapter 11 debtor does not have an absolute right to counsel of its choice." Id.

[5] Although the language of § 327(a) refers only to professionals employed by a trustee, the section also applies to professionals employed by a chapter 11 debtor in possession [FN2] pursuant to § 1107(a), which provides in relevant part, "a debtor in possession shall have all the rights ... and powers, and shall perform all the functions and duties ... of a trustee serving in a case under this chapter." See, e.g., In re Diamond Mortgage Corp., 135 B.R. 78, 88 (Bankr.N.D.III.1990) (stating that § 327(a) applies to professionals retained by a chapter 11 debtor in possession).

FN2. Professionals appointed to represent or assist a committee of creditors are governed by § 1103, which has different standards from § 327(a).

[6][7] Section 327(a) imposes a two-pronged test for the employment of professionals. The professional

(1) must not hold or represent any interest adverse to the estate, and (2) must be a "disinterested person." See, e.g., In re Granite Partners, L.P., 219 B.R. 22, 32 (Bankr.S.D.N.Y.1998) (interpreting § 327(a) to impose these two express requirements); In re Perry, 194 B.R. 875, 878 (E.D.Cal.1996) (same); In re Lee, 94 B.R. 172, 177 (Bankr.C.D.Cal.1988) (same). But see In re Martin, 817 F.2d 175, 180 (1st Cir.1987) (construing the twin requirements of 327(a) to "telescope into what amounts to a single hallmark"). This standard is high: "If there is any doubt as to the existence of a conflict, that doubt should be resolved in favor of disqualification." Lee, 94 B.R. at 177.

[8] Where a bankruptcy debtor is a creditor of a related debtor, it is presumptively improper for the same attorney (or law firm) to be general counsel for the related debtors. See, e.g., In re Interwest Bus. Equip., 23 F.3d 311, 316 (10th Cir.1994) (stating that separate counsel is required where intercompany debts placed each estate in a creditor/debtor relationship with another); Lee, 94 B.R. at 177 (stating that, absent appropriate consent, a law firm may not represent both a corporation and its sole shareholder in related chapter 11 cases); Gill v. Sierra Pacific Construction (In re Parkway 89 B.R. 832, Ltd.), Calabasas, (Bankr.C.D.Cal.1988) (adopting a presumption that the same counsel should not be appointed for related chapter 11 debtors where creditors have dealt with the debtors as an economic unit), rev'd on other grounds. Bankr.9th Cir.1990 (unpublished opinion), rev'd. 949 F.2d 1058 (9th Cir.1991)(adopting bankruptcy court opinion).

Rule 2014 of the Federal Rules of Bankruptcy Procedure sets forth the application *419 procedure for the employment of professionals. Rule 2014 requires an application to disclose, "to the best of the applicant's knowledge, all of the person's connections with the debtor, creditor, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Id. at 2014(a). Furthermore, the application must be supplemented by a verified statement of the prospective professional that makes these disclosures. Id.

[9] To make the determinations required under § 327(a), the court must be fully informed of any actual and potential conflicts of interest. The purpose of Rule 2014 is to assure that both the court and the parties in interest receive full disclosure of all actual or potential conflicts that might affect the

professional's representation of a trustee, committee or debtor in possession. *See, e.g., In re Lee Way Holding Co.,* 100 B.R. 950, 955 (Bankr.S.D.Ohio 1989).

[10] To obtain this information, the court principally relies on the employment application of the professional. See Envirodyne, 150 B.R. at 1020-21. Rule 2014 requires the applicant to disclose affirmatively all actual and potential conflicts of interest that may be relevant to determining whether the applicant meets the statutory requirements. See, e.g., In re Cleveland Trinidad Paving Co., 218 B.R. 385, 387-88 (Bankr, N.D.Ohio 1998) (stating that the applicant has a duty to disclose all facts relevant to determining counsel's eligibility for employment); Granite Partners, 219 B.R. at 35 (stating that proper disclosure permits the court to decide whether retention of the applicant should be approved); Diamond Mortgage, 135 B.R. at 97 (holding that disclosure allows the court to determine whether the professional has a conflict of interest). obligation to make full disclosure rests on the "fiduciary obligation that an attorney ultimately employed in a bankruptcy proceeding owes to the Court." Lee Holding, 100 B.R. at 956.

In addition to receiving information from the applicant, the court relies on other parties in interest to bring disqualifying conflicts of interest to the court's attention. For this reason, Local Rule 2014-1 requires the applicant to provide a disclosure notice to the debtor, the United States Trustee, the principal secured creditors, the creditors' committee, and all others who request special notice.

3. Rule 3-310 of California Rules of Professional Conduct

In addition to the requirements of § 327(a) and Rule 2014, the conduct of lawyers is governed by the applicable state rules of professional conduct. [FN3] See, e.g., Wilson v. Cumis Ins. Soc. (In re Wilson), 250 B.R. 686, 689 (Bankr.E.D.Ark.2000) (stating that the Texas lawyers in the case were subject to the rules of professional responsibility in Texas (because they were licensed there) and in Arkansas (pursuant to the local rules of the forum district)); *420 In re Jaeger, 213 B.R. 578, 583 (Bankr.C.D.Cal.1997) (applying California professional conduct rules pursuant to local rule of court); Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust), 195 B.R. 740 (Bankr.C.D.Cal.1996) (applying rules of professional conduct of several states to lawyers in international law firm with offices in numerous

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states); Captran Creditors Trust v. North Am. Title Ins. Agency (In re Captran Creditors Trust), 104 B.R. 442, 444 (Bankr.M.D.Fla.1989) (citing local rule adopting the Florida rules of professional conduct); In re Lee, 94 B.R. 172, 177-78 (Bankr.C.D.Cal.1988) (stating that the representation of conflicting interests is prohibited by the California Rules of Professional Conduct).

FN3. See Local Bankruptcy Rule 2090-1, incorporating by reference Local District Court Rule 83-3.1.2, which provides:

In order to maintain the effective administration of justice and the integrity of the Court, each attorney shall be familiar with and comply with the standards of professional conduct required of members of the State Bar of California and contained in the State Bar Act, the Rules of Professional Conduct of California, and the decisions of any court applicable thereto. These statutes, rules and decisions are hereby adopted as the standards of professional conduct, and any breach or violation thereof may be the basis for the imposition of discipline. The Model Rules of Professional Conduct of the Association may American Bar considered as guidance.

[11] In <u>California</u>, <u>Rule 3-310</u> of the California Rules of Professional Conduct prohibit counsel from representing adverse interests unless the client gives informed written consent. [FN4] Consent is required both for the representation of actual conflicting interests and potential conflicts of interest. See <u>In re Jaeger</u>, 213 B.R. 578, 585 (Bankr.C.D.Cal.1997) (stating that a second written waiver is required when a potential conflict of interest ripens into an actual conflict).

FN4. Rule 3-310 provides in relevant part:

(A) For the purposes of this rule:

(1) "Disclosure" means informing the client or former client of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences to the client or former client;

(2) "Informed written consent" means the client's or former client's written agreement to the representation following written disclosure. (B) A member shall not accept or continue representation of a client without

providing written disclosure to the client where:

- (1) The member has a legal, business, financial, professional, or personal relationship with a party or witness in the same matter
- (C) A member shall not, without the informed written consent of each client:
- (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or
- (2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict.

B. Actual and Potential Conflicts of Interest

[12] Neither § 327 nor Rule 2014 defines what constitutes a conflict of interest for an attorney. Accordingly, we turn to California law to determine this issue.

traditionally interest law has Conflict of distinguished between actual and potential conflicts However, there is no definitive of interest. formulation of this distinction. See discussion in In re McKinney Ranch Assocs., 62 B.R. 249, 253-54 (Bankr.C.D.Cal.1986). The ABA Model Rules or Professional Conduct ("ABA Model Rules"), which are in force in most states (but not California), for example, define an actual conflict of interest as one that is "directly adverse" to another client or that is "materially limited" by the representation of another client. See ABA Model Rules R. 1.7. As in McKinney, in this case the court will not be required to determine the exact line between potential and actual conflicts of interest.

Potential conflicts of interest come in enormously varying degrees. Some are quite likely to ripen into actual conflicts of interest. The likelihood of the development of other potential conflicts into actual conflicts may be very remote. Indeed, any lawyer with at least two clients has at least a remote potential conflict of interest: those two clients may somehow develop a conflict, and the lawyer could then represent conflicting interests.

[13] Section 327(a) prohibits an attorney (or other professional) from representing *421 a debtor in a chapter 11 case if the attorney has or represents an actual conflicting interest. This prohibition is absolute, and is not subject to waiver or consent. See, e.g., Envirodyne, 150 B.R. at 1016; Diamond

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<u>Mortgage</u>, 135 B.R. at 90; <u>Amdura</u>, 121 B.R. at 866; <u>In re O'Connor</u>, 52 B.R. 892, 897 (Bankr.W.D.Okla.1985).

[14] In addition, § 327 also prohibits an attorney from holding or representing a certain level of potential conflicts of interest. Employment may not be approved where a potential conflict creates a meaningful incentive to act contrary to the best interests of the estate and its various creditors. See, e.g., Granite Partners, 219 B.R. at 33.

[15][16] Thus an actual conflict of interest creates a violation of § 327. A potential conflict of interest may also require the disqualification of a professional if, in the judgment of the court, the conflict is sufficiently important and there is a sufficient likelihood that it will ripen into an actual conflict. See, e.g., In re Amdura, 121 B.R. 862, 865-68 (Bankr.D.Colo.1990) (potential conflict required disqualification because any viable chapter 11 plan would require bringing litigation against a bank that provided a substantial portion of the revenue of the law firm applying for appointment as counsel for debtor). However, as the First Circuit states in Martin. "[t]he naked existence of a potential for conflict of interest" does not prohibit employment under § 327(a). 817 F.2d at 182. "It is for the court to decide whether the attorney's proposed interest carries with it a sufficient threat of material adversity to warrant ... disqualification" Id.

C. Appearance of Impropriety

[17] A number of reported cases also state that an attorney may not be employed under § 327 if such employment would create "the appearance of impropriety." See, e.g., Martin, 817 F.2d at 180-81; In re Filene's Basement, Inc., 239 B.R. 850, 857 (Bankr.D.Mass.1999); Granite Partners, 219 B.R. at 34; Diamond Mortgage, 135 B.R. at 91.

Except for the states where attorney conduct is still governed by the ABA Model Code of Professional Responsibility (which the ABA Model Rules replaced in 1983), United States lawyers are no longer subject to a rule requiring them to avoid conduct that creates the appearance of impropriety. [FN5] In fact, California never adopted such a rule.

FN5. The following states have not adopted the ABA Model Rules, and still have rules governing attorney conduct based on the ABA Model Code of Professional

Responsibility, and still impose a duty on lawyers to avoid the appearance of impropriety: Iowa, Nebraska, New York, Ohio and Oregon.

It appears that most, if not all, cases incorporating the "appearance of impropriety" standard into § 327 either arose in states that had not yet adopted the ABA Model Rules (which abolished this provision), or were based on prior precedent of that vintage. Furthermore, it appears that the "appearance of impropriety" standard has not been applied in any reported cases to non- attorney professionals.

In this court's view, the "appearance of impropriety" standard was never a requirement of § 327 itself. Instead, it was imported into the requirements of § 327 for attorneys from state rules of professional conduct, and was applied in those states where these rules included an "appearance of impropriety" prohibition. Where this rule has now disappeared, and in states such as California where the rule never existed, the court finds that § 327 does not impose such a requirement.

*422 D. Application to Facts of These Cases

These three related cases are rife with potential conflicts of interest. The potential conflicts of interest among the debtors create the potential for counsel to represent conflicting interests.

[18] While the appointment of the same counsel in related chapter 11 cases is presumptively improper, prospective counsel may seek to rebut the presumption at a hearing on notice to all creditors in each of the related cases. See Lee, 94 B.R. at 180. The notice must be sufficient to inform all creditors that the appointment may result in conflicts of interest and lack of adequate representation of the interests of the respective bodies of creditors. See id.

The main potential conflict of interest in these cases arises from the fact that CCA is the secured creditor in first position for each debtor, and each of the loans is cross-collateralized, at least to a certain degree, by a second mortgage on the property belonging to each of the other debtors. Thus each debtor is a potential creditor of the other debtors, and would become an actual creditor if the second mortgagee pays part or all of the debt owing principally by another debtor.

The degree of cross-collateralization differs from one debtor to the next. For Wheatfield, the second

mortgage is limited to \$150,000 in principal. For Poughkeepsie, the second mortgage is limited to \$1,029,898. For Hebron, in contrast, the second mortgage is unlimited in amount.

Because of the limitations on the second mortgages in the Wheatfield and Poughkeepsie cases, it appears that both of their properties have equity for the owners. In contrast, the Hebron property is deeply under water as to the first mortgage alone, and the unlimited second is entirely unsupported by value in the property.

There are two additional inter-debtor transactions that remain in consequence of the common development plan. First, there are documents that indicate that Poughkeepsie owed \$1,833,013 to Wheatfield before the bankruptcy filing, but a few days before the filing Wheatfield sold the loan to Bicycle Partners, another Lichter entity. [FN6] Second. Poughkeepsie owes an unsecured debt of \$80,000 to Wheatfield.

> FN6. It is uncertain whether there is any this economic reality to apparent indebtedness, and Poughkeepsie has commenced litigation to avoid the lien.

E. Consent to Representation of Conflicting Interests

Professional responsibility rules traditionally have permitted clients to waive conflicts of interest of their lawyers. We turn now to an examination of whether such waiver or consent is permitted under § 327.

1. Consent May be Permitted in Appropriate

Rule 3-310 of the California Rules of Professional Conduct authorizes a lawyer to represent more than one client with potential or actual conflicting interests, or to represent a client in a separate matter whose interest in the first matter is adverse to the client in the first matter. See id. at 3-310(c). Such representation requires the informed written consent of each client after full written disclosure to the affected clients of the relevant circumstances and the reasonably foreseeable adverse consequences thereof. See id. at 3-310(a); see also ABA Model Rules R. 1.7 (2002) (requiring client consent after full disclosure for the representation of conflicting interests). In addition, Rule 3-310(b) permits a lawyer to represent a client after similar written disclosure (but *423 without requiring client consent) where the lawyer has or had certain connections with other parties, witnesses, or the subject matter of the representation.

There is an important difference between the requirements of Rule 3-310 and the apparent requirements of § 327(a). Rule 3-310(c) permits a client to consent to the prohibited conflicts of interest, and Rule 3-310(b) presumes consent upon the written disclosure of a conflict covered by that provision. The ABA Model Rules have similar See ABA Model Rules R. consent provisions. 1.7(b)(4) (2002). Section 327(a), in contrast, has no explicit provision for waiver or consent to the representation of conflicting interests.

At the same time, there is nothing in § 327, or any other bankruptcy law provision, to indicate that the foregoing rules, authorizing consent to the representation of conflicting interests, do not apply to attorneys appointed under § 327(a).

[19] The court finds that, in certain circumstances, a waiver [FN7] of a potential conflict of interest may be given for employment subject to the standards of § 327. While the policy of § 327(a) requires that a professional give undivided loyalty to the client, this policy is waivable in appropriate cases if the parties in interest so desire. Indeed, the number of related cases may be so large that an inflexible rule would be See, e.g., In re Cardinal totally unworkable. Industries, 105 B.R. 834 (Bankr.S.D.Ohio 1989) (involving a business empire of more than 1000 related entities, approximately half of which filed chapter 11 cases in Columbus, Ohio).

> FN7. The court's ruling in this case does not suggest that other provisions of the Bankruptcy Code are also subject to waiver. The vast majority of the provisions of this law are mandatory, in this court's view, and not subject to waiver.

[20] The presumption, articulated in Parkway Calabasas, against the appointment of a single attorney or law firm to represent related entities that have filed chapter 11 cases is rebuttable. Whether such joint representation is appropriate turns on the facts of the particular cases at issue. See Interwest. 23 F.3d at 318-19. In some cases, the protection of creditors may require separate representation. In

other cases, joint representation may be in the best interests of the creditors.

[21][22] However, waiver or consent to the representation of potential conflicting interests is not available under § 327 to the same degree as in non-bankruptcy cases. The higher standards applicable to professionals in bankruptcy cases require the court to make a more careful inquiry than is required outside of bankruptcy. Furthermore, courts must consider the disqualification issue under § 327 on a case by case basis. See, e.g., In re Martin, 817 F.2d 175, 182 (1st Cir.1987); Envirodyne, 150 B.R. at 1017; Lee, 94 B.R. at 180.

As explained supra, if there is an actual conflict of interest, joint representation of related debtors cannot be authorized. However, a potential conflict may be avoided in some cases by the appointment of special counsel to handle the issues involving the conflict of For example, if a potential conflict of interest. interest arises because of a transaction between two affiliated business entities that are both debtors in chapter 11 cases, the appointment of special counsel to deal with that transaction may be sufficient to permit a single attorney or law firm to represent the related entities as their general chapter 11 counsel. Alternatively, responsibility for analyzing such a transaction and perhaps litigating with respect to it may be given to *424 counsel for the creditors committee, if such a committee is active in the case. [FN8]

FN8. See, e.g., Official Unsecured Creditors Comm. v. U.S. Nat'l Bank (In re Sufolla, Inc.), 2 F.3d 977, 979 n. 1 (9th Cir.1993) (stating that § 1103(c)(5) contains a qualified implied authorization for a creditors' committee to initiate an adversary proceeding on behalf of a bankruptcy estate).

[23] Before the court makes such a decision, the creditors must be notified and given an opportunity to be heard. The notice must be sufficient to provide adequate information to the creditors of the proposed joint representation and the known potential conflicts of interest. See <u>Lee</u>, 94 B.R. at 180.

2. Who May Consent

[24] The more difficult issue is determining whose consent must be obtained to authorize the

representation of conflicting interests. Because a debtor in bankruptcy is presumptively insolvent, the residual stakeholders are presumptively the creditors rather than the shareholders. See <u>Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust)</u>, 195 B.R. 740, 750 (Bankr.C.D.Cal.1996).

<u>Lee</u> illustrates the requirements of providing disclosure and obtaining consent waivers from the appropriate parties. <u>Lee</u> involved bankruptcy cases filed by both a corporation and by its sole shareholder. Both debtors applied for appointment of the same law firm as general counsel, but failed to disclose the proposed joint representation. When the court brought this problem to counsel's attention, counsel stated that his representation of each debtor did not represent conflicting interests because the corporation was not a creditor of the shareholder and the shareholder was willing to waive any claims he had against the corporation.

The court in <u>Lee</u> first held that a shareholder cannot unilaterally waive its claims against a corporation after the filing of the shareholder's bankruptcy case. <u>Lee</u>, 94 B.R. at 178. Second, <u>Lee</u> holds that where there is a potential conflict of interest, consent or waiver is necessary. <u>Lee</u> states, "[a]n attorney who desires to represent a debtor in possession and a conflicting interest must obtain a written waiver from the debtor, all creditors, and the United States Trustee." <u>Id.</u> at 179. However, the court retains discretion to determine whether such a waiver is sufficient to cure a potential conflict of interest, even if all the parties have consented. <u>Id.</u>

One of the most carefully reasoned cases on attorney conflicts of interest is In re Perry, 194 B.R. 875 (E.D.Cal.1996), where the district court found no abuse of discretion in the bankruptcy court's denial of fees to counsel for a chapter 7 trustee who also represented on unrelated matters a prospective purchaser of estate property. The district court in Perry affirmed the bankruptcy court's finding that the trustee's counsel had an actual conflict of interest resulting from the simultaneous representation of both the trustee and the prospective purchaser, which See id. at 879. was only belatedly disclosed. Furthermore, as a result of the conflict, counsel had failed to pursue vigorously a much higher offer received from another prospective purchaser and failed to take other action to facilitate the acceptance of the higher offer. See id. at 879-81.

The failure to make timely disclosure of the conflict, the court found in <u>Perry</u>, was alone a sufficient basis

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for the denial of fees. See <u>id.</u> at 879. The court in <u>Perry</u> also found that, notwithstanding the rules of professional conduct, § 327 does not permit a chapter 11 debtor to waive a conflict by signing a waiver, because the *425 ultimate parties in interest are the creditors of the bankruptcy estate. <u>[FN9]</u> See id

FN9. The heading to this section in <u>Perry</u> overstates the law when it states, "The Bankruptcy Court was correct in finding that the conflict of interest could not be waived." See <u>id.</u> at 879. In fact, the text of the court's decision takes a more modest position: the chapter 11 debtor cannot waive a conflict of interest because the ultimate parties in interest are the creditors.

3. How to Obtain Consent

The courts in both <u>Perry</u> and <u>Lee</u> did not reach the issue of how the creditors can waive a conflict of interest that would otherwise disqualify debtor's counsel. This court must now address this issue.

BBZ has obtained consents from each of the debtors in the related cases before the court. The United States Trustee has also given her consent, on condition that special counsel be employed to litigate any inter-debtor claims. However, these consents are not sufficient, because the creditors are not included.

Bankruptcy has a distinctive system for obtaining the consent of creditors for a variety of actions to be taken in the case. The standard procedure is to give notice to creditors of a proposed course of action, and to give them an opportunity to object. This procedure is generally provided by § 102(1), which provides:

In this title--

- (1) "after notice and a hearing", or a similar phrase-
- (A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but
- (B) authorizes an act without an actual hearing if such notice is given properly and if--
- (i) such a hearing is not requested timely by a party in interest

Under this provision, action can be taken on behalf of the estate (and in other situations, also) after giving the appropriate notice. [FN10] While the

court may require a hearing, the court may also authorize the action in question without a hearing if no objection is made.

FN10. Local Bankruptcy Rule 9013-1(g) implements § 102(1) by specifying 15 types of actions (none of which is relevant here) that can be taken with notice where no hearing is required absent opposition.

Because bankruptcy law is federal law, the bankruptcy law procedure applies in this case, rather than California procedure. Pursuant to the Supremacy Clause of the United States Constitution, [FN11] the bankruptcy law procedure preempts the California law procedure.

FN11. Article VI of the United States Constitution provides in relevant part: This Constitution, and the Laws of the United States which shall be made in Pursuance thereof ... shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

[25][26] Notice to all creditors may be required in a particular case for an application to represent related chapter 11 debtors. In other cases, notice to the committee of creditors (or the twenty largest unsecured creditors, in the absence of a committee), the principal creditors, and other creditors who have requested special notice may be sufficient. In determining who should receive such notice, the court must consider the size of the creditor body, the nature of the potential conflicts at issue, and any other relevant circumstances.

*426 [27] In this case the number of creditors in each case is relatively small, so that there is no substantial burden in giving the appropriate notice to all creditors. In addition, the potential conflicts of interest are sufficiently weighty that all creditors should receive effective notice.

IV. CONCLUSION

The court concludes that the debtors can obtain consent of the creditors for the representation of related chapter 11 entities, such as those before the

court, by giving the creditors notice that makes full disclosure of the proposed joint representation and the known potential conflicts of interest. If a creditor fails to object to the representation, the creditor thereby waives the application of § 327(a) and any right to object, and consents to the representation. If creditor consent is obtained by this process, the court will be in position to determine whether the joint representation in this case should be authorized.

Because the court has not received evidence that full disclosure has been given to creditors in these procedurally consolidated cases, approval of the joint employment must await such evidence.

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(Cite as: 315 F.3d 217)

C

United States Court of Appeals, Third Circuit.

In re: UNITED ARTISTS THEATRE COMPANY, et al., Debtors

v

[FN*]Donald F. WALTON, Acting United States Trustee for Region 3

FN* Substituted Pursuant to F.R.A.P. 43(c)

*Donald F. Walton, Appellant

No. 01-1351.

Argued Dec. 4, 2001. Filed Jan. 9, 2003.

Chapter 11 debtors filed application to retain financial advisor. United States Trustee (UST) objected on grounds that the retention agreement exempted advisor from liability for its own ordinary negligence. The United States District Court for the District of Delaware, Sue L. Robinson, Chief Judge, approved application, and subsequently confirmed plan of reorganization. UST appealed. The Court of Appeals, Ambro, Circuit Judge, held that: (1) UST had standing to challenge the agreement's indemnification provision; (2) provisions of confirmed plan did not render case constitutionally or equitably moot, and, addressing an issue of apparent first impression for the court; (3) the subject indemnification agreement was reasonable and, therefore, permissible under the Bankruptcy Code.

Affirmed.

Alito, Circuit Judge, filed concurring opinion.

Rendell, Circuit Judge, filed concurring opinion.

West Headnotes

11 Bankruptcy 3533.1 51k3533.1 Most Cited Cases

11 Bankruptcy 3539.1 51k3539.1 Most Cited Cases

"Prenegotiated bankruptcies" have plans of

reorganization and disclosure statements filed shortly after the cases themselves file, usually before the committee of unsecured creditors is formed, in contrast with typical Chapter 11 cases, where a plan and disclosure statement are filed many months, sometimes years, after the cases are filed, and "prepackaged bankruptcies," or "prepacks," where the plan and disclosure statement are filed, and sufficient favorable votes on the plan are solicited and obtained, before the Chapter 11 case begins, leading to a prompt plan confirmation.

[2] Bankruptcy 3767 51k3767 Most Cited Cases

District court's approval of a professional's retention by a debtor is a final order. 28 U.S.C.A. § 1291.

[3] Bankruptcy 3836 51k3836 Most Cited Cases (Formerly 51k3784, 51k3782)

Court of Appeals reviews the district court's approval of professional persons under the Bankruptcy Code for abuse of discretion, but reviews its legal determinations de novo. Bankr.Code, 11 U.S.C.A. § 327(a), 328(a).

14 Bankruptcy 2204.1 51k2204.1 Most Cited Cases

Lack of pecuniary interest in the outcome of a bankruptcy proceeding does not deny the United States Trustee (UST) standing to raise, appear, and be heard on an issue in the proceeding. Bankr.Code, 11 U.S.C.A. § 307.

15] Bankruptcy 3008.1 51k3008.1 Most Cited Cases

"United States Trustees" (USTs) are officers of the Department of Justice who protect the public interest by aiding bankruptcy judges in monitoring certain aspects of bankruptcy proceedings.

[6] Bankruptcy € 2159.1 51k2159.1 Most Cited Cases

United States Trustee (UST) had standing to challenge indemnification provision of Chapter 11 debtors' retention agreement with proposed financial advisor, Bankr.Code, 11 U.S.C.A. § 307.

[7] Federal Courts € 12.1

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40 Bankr. Ct. Dec. 182, Bankr. L. Rep. P 78,777

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170Bk12.1 Most Cited Cases

If a case is constitutionally moot, court lacks the power to hear it.

181 Bankruptey 3781 51k3781 Most Cited Cases

Appeal is "moot" in the constitutional sense only if events have taken place that make it impossible for the court to grant any effectual relief whatever.

191 Bankruptcy 3836 51k3836 Most Cited Cases (Formerly 51k3781)

Appeal is not moot merely because a court cannot restore the parties to the status quo ante, that is, the state in which they were before.

101 Bankruptey 3836 51k3836 Most Cited Cases (Formerly 51k3781)

When a court can fashion some form of meaningful relief, even if it only partially redresses the grievances of the prevailing party, the appeal is not moot.

111 Bankruptcy 3781 51k3781 Most Cited Cases

Provision of confirmed Chapter 11 plan, releasing debtors and their professionals from suits by each holder of a claim who had accepted the plan, did not render constitutionally moot the United States Trustee's (UST's) appeal from the district court's approval of debtors' application to retain financial advisor; release provision did not bind all holders of claims, but covered only those who accepted the plan, so that, by its own terms, the release allowed future claims, and in any event the Court of Appeals could have provided relief by modifying the retention order.

12 Bankruptcy 3021 51k3021 Most Cited Cases

12 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Debtors and their professionals cannot exempt themselves from liability to non- consenting parties merely by saying the word.

13 Bankruptcy 3555 51k3555 Most Cited Cases

Hallmarks of permissible non-consensual releases, in bankruptcy context, are fairness, necessity to the reorganization, specific factual findings to support these conclusions, and that the releases were given in exchange for fair consideration.

[14] Bankruptcy 3781 51k3781 Most Cited Cases

Release provision of confirmed Chapter 11 plan, excepting from liability the debtors and their professionals for plan- or case-related action and inaction, did not render constitutionally moot the United States Trustee's (UST's) appeal from the district court's approval of debtors' application to retain financial advisor; provision contained carveouts for gross negligence and willful misconduct, and the release was not backed by adequate findings of fairness, necessity to reorganization, and reasonable consideration.

115] Bankruptcy € 3836 51k3836 Most Cited Cases (Formerly 51k3786, 51k3781)

Pursuant to the doctrine of equitable mootness, the Court of Appeals considers five factors in determining whether it would be equitable or prudential to reach the merits of a bankruptcy appeal: (1) whether the reorganization plan has been substantially consummated, (2) whether a stay has been obtained, (3) whether the relief requested would affect the rights of parties not before the court, (4) whether the relief requested would affect the success of the plan, and (5) the public policy of affording finality to bankruptcy judgments.

116 Bankruptcy 3836 51k3836 Most Cited Cases (Formerly 51k3781)

Confirmation of Chapter 11 plan did not, pursuant to the doctrine of equitable mootness, preclude the Court of Appeals from considering the United States Trustee's (UST's) appeal from the district court's approval of debtors' application to retain financial advisor; relief sought by the UST did not entail "knocking out the props" under the plan, UST instead requested only that provision indemnifying advisor for negligent conduct be stricken from its retention

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agreement, plan would otherwise survive intact even if the Court of Appeals were to modify the indemnity provision, and allowing challenge to indemnity provision on public policy grounds was itself sound public policy.

17] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

117 Bankruptcy 3160 51k3160 Most Cited Cases

17] Bankruptcy 3192 51k3192 Most Cited Cases

Bankruptcy Code requires that the terms and conditions of employment of any professionals engaged under the Code be "reasonable." Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

18 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

18 Bankruptcy 3160 51k3160 Most Cited Cases

118 Bankruptcy 3192 51k3192 Most Cited Cases

Some reference to the market is not out of place when considering whether terms of a professional's retention are "reasonable" in the bankruptcy context. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

19 Bankruptcy 3029.1 51k3029.1 Most Cited Cases

[19] Bankruptcy 3160 51k3160 Most Cited Cases

119 Bankruptcy 3192 51k3192 Most Cited Cases

In determining whether terms of a professional's retention are "reasonable" under the Bankruptcy Code, court's approach is "market driven," not "market-determined," given the special supervisory role played by courts in the realm of bankruptcy. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

[20] Corporations 308(1) 101k308(1) Most Cited Cases

Corporate directors and officers in Delaware may obtain indemnity for their own negligence. <u>8 Del.C.</u> § 145(a, b).

1211 Corporations 307 101k307 Most Cited Cases

Directors and officers are fiduciaries of the corporations they serve.

[22] Corporations 310(2) 101k310(2) Most Cited Cases

Under Delaware law, gross negligence, as opposed to ordinary negligence, is the standard for liability of corporate directors.

101k310(2) Most Cited Cases

Under Delaware law, in determining whether corporate directors have acted with the requisite degree of negligence for liability, courts evaluate the process by which boards reach decisions, rather than the final result of those decisions.

101k310(2) Most Cited Cases

Under Delaware law, a board's failure to inform itself of all material information reasonably available results in a finding of gross negligence.

[25] Corporations € 310(1) 101k310(1) Most Cited Cases

Under Delaware law, compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed; that is, whether a judge or jury, considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests.

[26] Bankruptcy € 3029.1 51k3029.1 Most Cited Cases

Job of Chapter 11 debtors' financial advisor was to



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advise debtors well, and it owed them a duty of care in fulfilling this obligation. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

When financial advisors retained by debtors (1) have no personal interest, (2) have a reasonable awareness of available information after prudent consideration of alternative options, and (3) provide that advice in good faith, courts do not interfere with the advisors' advice.

101k310(1) Most Cited Cases

[28] Corporations 312(1) 101k312(1) Most Cited Cases

128 Corporations 314(1) 101k314(1) Most Cited Cases

"Business judgment rule," a creature of common law, acknowledges a judicial syllogism derived from five fundamental tenets: (1) management of corporation's affairs is placed by law in the hands of its board of directors, (2) performance of directors' management function consists of (a) decision- making, that is, the making of economic choices and the weighing of the potential of risk against the potential of reward, and (b) supervision of officers and employees, that is, attentivenessto corporate affairs, (3) corporate directors are not guarantors of the financial success of their management efforts, (4) though not guarantors, directors as fiduciaries should be held accountable to corporation and legally stockholders when their performance falls short of meeting appropriate standards, and (5) such culpability occurs when directors breach their fiduciary duty, that is, when they breach the "duty of loyalty" by profiting improperly from their positions, or breach the "duty of care" by failing to supervise corporate affairs with the appropriate level of skill. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

[29] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Indemnity arrangement between Chapter 11 debtor and its financial advisor that includes common negligence may be approved as reasonable. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

[30] Bankruptcy € 3029.1 51k3029.1 Most Cited Cases

Indemnification provision contained in Chapter 11 debtors' retention agreement with financial advisor, which exempted advisor from liability for its own ordinary negligence, was reasonable and, thus, permissible under the Bankruptcy Code; there was no evidence before the district court that tended to disqualify advisor under the tenets used in determining reasonableness, as affidavit submitted in support of debtors' retention application stated that advisor was "disinterested," and there were no allegations that advisor imprudently considered the financial options available to debtors, or that it acted in bad faith. Bankr.Code, 11 U.S.C.A. § § 327, 328(a).

[31] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

Provision in Chapter 11 debtors' retention agreement with financial advisor, which, in effect, mandated indemnification to advisor for even its gross negligence if that negligence was not judicially determined to be "solely" the cause of its damages, went outside the bounds for acceptable public policy. Bankr.Code, 11 U.S.C.A. § \$ 327, 328(a).

[32] Bankruptcy 3029.1 51k3029.1 Most Cited Cases

To the extent that Chapter 11 debtors' financial advisor sought, in its retention agreement, indemnity for a contractual dispute in which debtors alleged the breach of advisor's contractual obligations, such conduct was hardly an indemnity-eligible activity. Bankr.Code, 11 U.S.C.A. § \$ 327, 328(a).

*221 James H.M. Sprayregen, James W. Kapp, III (Argued), <u>David J. Zott</u>, Kirkland & Ellis, Chicago, IL, for Appellee United Artists Theatre Company, et al.

Richard A. Chesley (Argued), Houlihan Lokey Howard & Zukin, Chicago, IL, for Appellee Houlihan Lokey Howard & Zukin.

Bruce G. Forrest (Argued), United States Department of Justice, Civil Division, Appellate Staff, Washington, DC, for Appellant Acting United States Trustee.

Before: ALITO, RENDELL, and AMBRO, Circuit

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Judges.

OPINION OF THE COURT

AMBRO, Circuit Judge.

The United States Trustee (the "U.S. *222 Trustee") [FN1] appeals the District Court of Delaware's approval of a bankruptcy debtor's application to retain a financial advisor. Specifically, the U.S. Trustee objects to the debtor's agreement to indemnify the financial advisor for claims of negligence (as opposed to gross negligence) that may be leveled against it. We first address whether the U.S. Trustee has standing to bring this suit, and determine that he does. Next we examine whether subsequent confirmation of the reorganization plan renders this case constitutionally or equitably moot. After concluding that it is not moot in either sense, we turn to the merits of the U.S. Trustee's appeal. We affirm the District Court's ruling that the indemnification provision is permissible, though we do so in a way that eschews the inherent imprecision between shades of negligence. In so doing, we borrow from corporate law analogues, and focus on the process by which financial advisors reach their opinions rather than on the substance of the opinions themselves.

FN1. Patricia A. Staiano was the U.S. Trustee at the time of briefing, but her term expired on October 5, 2001. Her current replacement is Acting U.S. Trustee Donald F. Walton.

I. Background

United Artists Theatre Company and affiliates [FN2] (collectively, the "Debtors" or "United Artists") filed for Chapter 11 bankruptcy protection in the District Court. [FN3] At the outset the Debtors requested court approval of their retention of Houlihan, Lokey, Howard & Zukin Capital ("Houlihan Lokey") as financial advisor. The engagement letter provided that United Artists would indemnify Houlihan Lokey's reasonable attorneys' fees and expenses, as well as any losses incurred by Houlihan Lokey with respect to, *inter alia*, its providing of services. The letter also contained an exception for "any Losses that are finally judicially determined to have resulted from the gross negligence, bad faith, willful misfeasance, or reckless

disregard of its obligations or duties on the part of Houlihan Lokey." [FN4]

FN2. These affiliates are United Artists Theatre Circuit, Inc., United Artists Realty Company, United Artists Properties I Corp., United Artists Properties II Corp., UAB, Inc., UAB II, Inc., Mamaroneck Playhouse Holding Corporation, Tall the Inc., UA Theatre Amusements, Inc., UA International Property Holding, Inc., UA Property Holding II, Inc., United Artists International Management Company, Beth Page Theatre Co., Inc., United Film Distribution Company of South America, U.A.P.R., Inc., R and S Theatres, Inc., and King Reavis Amusement Company.

FN3. The District Court of Delaware's relationship with the United States Bankruptcy Court for the District of Delaware has a checkered past. The District Court revoked the automatic reference of bankruptcy cases to the Bankruptcy Court effective February 3, 1997. In December of 2000, the District Court reinstated the automatic referral, and then revoked it once more in April of 2001. An order dated September 6, 2001 again reinstated the automatic reference. Revoking the automatic reference means in practical terms that bankruptcy cases are assigned to the District Court unless, on a case-by-case basis, they are referred to the Bankruptcy Court. The District Court retained this case. which was filed while the reference revocation was in effect.

<u>FN4.</u> The principal indemnity provisions of the retention agreement are as follows:

(a) If Houlihan Lokey or any employee, agent, officer, director, attorney, shareholder or any person who controls Houlihan Lokey (any or all of the foregoing, hereinafter an "Indemnified Person") becomes involved in any capacity in any legal or administrative action, suit, proceeding, investigation or inquiry, regardless of the legal theory or the allegations made in connection therewith, directly or indirectly in connection with, arising out of, based upon, or in any way related to (i) the Agreement; (ii) the services

> that are the subject of the Agreement; (iii) any document or information, whether verbal or written, referred to herein or supplied to Houlihan Lokey; (iv) the breach of the representations, warranties or covenants by the Company given pursuant hereto; (v) Houlihan Lokey's involvement in the Transaction or any part thereof; (vi) any filings made by or on behalf of any party with any governmental agency in connection with the Transaction; (vii) the Transaction; or (viii) proceedings by or on behalf of any creditors or equity holders of the Company, the Company will on demand, advance or pay promptly, on behalf of each Indemnified Person, reasonable attorneys' fees and other expenses and disbursements (including, but not limited to, the cost of any investigation and related preparation) as they are incurred by the Indemnified Person. The Company also indemnifies and holds harmless each Indemnified Person against any and all losses, claims, damages, liabilities, costs and expenses (including, but not limited to, attorneys' fees, disbursements and court costs, and costs of investigation and preparation) ("Losses") to which such Indemnified Person may become subject in connection with any such matter.

(b) If for any reason the foregoing indemnification is determined to be unavailable to any Indemnified Person or insufficient fully to indemnify any such person, then the Company will contribute to the amount paid or payable by such person as a result of any such Losses in such proportion as is appropriate to reflect (i) the relationship between Houlihan Lokey's fee on the one hand and the aggregate value of the Transaction on the other hand or (ii) if the allocation provided by clause (i) is not permitted by applicable law, not only such relative benefit but also the relative fault of the other participants in the Transaction, on the one hand, and Houlihan Lokey and the Indemnified Persons on the other hand, and any other relevant equitable considerations in connection with the matters as to which such Losses relate; provided, however, that in no event shall the amount to be contributed by all Indemnified Persons in the aggregate exceed the amount of the fees actually received by Houlihan Lokey hereunder.

(c) Any Indemnified Person shall have the

right to employ such person's own separate counsel in any such action, at the Company's expense, and such counsel shall have the right to have charge of such matters for such person.

The (d) indemnification obligations hereunder shall not apply to any Losses that are finally judicially determined to have resulted from the gross negligence, bad faith, willful misfeasance, or reckless disregard of its obligations or duties on the part of Houlihan Lokey or such Indemnified Person. In the event of such final judicial determination, the Company shall, subject to Houlihan Lokey's rights of contribution, be entitled to recover from the Indemnified Person or Houlihan Lokey the costs and expenses paid on behalf of such Indemnified Person pursuant to this indemnification obligation.

In addition, United Artists' application to retain Houlihan Lokey supplemented the gross negligence and willful misconduct carveouts for indemnity in subparagraph (d) above by providing that, in the case of a judicial determination, it must be final and find that either the gross negligence or willful misconduct is "solely" the cause of any claim or expense of Houlihan Lokey. The order approving the application contains the same language.

The application and order also provide indemnity to Houlihan Lokey for its "prepetition performance of services." The U.S. Trustee, however, appeals only whether "indemnification provisions, holding a financial advisor harmless for the consequences its negligence of in connection with services it provides to the debtors in a bankruptcy proceeding," are reasonable under 11 U.S.C. § 328(a) (emphasis added).

*223 [1] The U.S. Trustee objected, claiming, inter alia, that the retention agreement exempted Houlihan Lokey from liability for its own negligence, thus violating the Bankruptcy Code, public policy, and basic tenets of professionalism. Specifically, it argued that the agreement was unreasonable under two provisions of the Bankruptcy Code, 11 U.S.C. § 327(a) and 328(a), because allowing a debtor's estate *224 to indemnify a financial advisor for its own negligence undermines the principal purpose of bankruptcy--conserving the debtor's assets in order to

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pay its creditors. The District Court, rejecting the U.S. Trustee's objections, approved the Debtors' retention of Houlihan Lokey in a memorandum order dated December 1, 2000 (though not entered on the docket until December 8, 2000). The Debtors' cases then proceeded as "prenegotiated" bankruptcies. [FN5] The confirmation hearing for the Debtors' second amended joint plan of reorganization ("the Plan") was held on January 22, 2001. The District Court confirmed the Plan that day (though the order was not docketed until January 25, 2001). On February 5, 2001, the U.S. Trustee filed this appeal.

FN5. "Prenegotiated" bankruptcies have plans of reorganization and disclosure statements filed shortly after the cases themselves file. usually before committee of unsecured creditors is formed. In re Pioneer Fin. Corp., 246 B.R. 626, 630 (Bankr.D.Nev.2000); see also Report of the Del. State Bar Ass'n to the Nat'l Bankr.Rev. Comm'n in Support of Maintaining Existing Venue Choices 18 n.39 (October 3, 1996). This contrasts with typical Chapter 11 cases, where a plan and disclosure statement are filed many months (sometimes years) after the cases are filed, and "prepackaged bankruptcies" (or "prepacks"), where the plan and disclosure statement are filed, and sufficient favorable votes on the plan are solicited and obtained, before the Chapter 11 case begins, leading to a prompt plan confirmation. See generally Marcia L. Goldstein et al., Prepackaged Chapter 11 Case Considerations and Techniques, in 1 Gotshal & Manges, Weil. Reorganizing Failing Businesses ch. 12 (Marvin E. Jacob & Sharon Youdelman eds.1998); Alesia Ranney-Marinelli, Prepackaged Plans of Reorganization, in A Practical Guide to Out-Of-Court Restructurings and Prepackaged Plans of Reorganization § 4.01[A], at 4-9 (Nicholas P. Saggese & Alesia Ranney-Marinelli eds., 2d ed.2000).

At the time of Plan confirmation the U.S. Trustee did not object to several provisions releasing Houlihan Lokey from liability. Article X(B) provided:

[O]n and after the Effective Date, each of the Debtors, the Reorganized Debtors, their subsidiaries, their affiliates, and the Releasees, and the agents, officers, directors, partners, members,

professionals, and agents of the foregoing (and the directors, partners, members. professionals, and agents of each thereof), for good and valuable consideration ... shall automatically be deemed to have released each other unconditionally and forever from any and all Claims, obligations, rights, suits, damages, Causes of Action, remedies and liabilities whatsoever, whether liquidated or unliquidated, fixed or contingent, matured or unmatured, known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, that any of the foregoing entities would have been legally entitled to assert (in their own right, whether individually or collectively, or on behalf of any Holder of any Claim or Equity Interest or other Person or Entity), based in whole or in part upon any act or omission, transaction, agreement, event or other occurrence taking place on or before the Effective Date, relating in any way to the Debtors, the Reorganized Debtors, the Chapter 11 Cases, the Plan, the Disclosure Statement, or any related agreements, instruments other documents....

Article X(C) read as follows:

On and after the Effective Date, each Holder of a Claim who has accepted the Plan, in exchange for, among other things, a distribution under the Plan, shall be deemed to have released unconditionally each of the Debtors, the Reorganized Debtors ... and the agents, officers, directors, partners, members, professionals, and agents of the foregoing (*225 and the officers, directors, partners, members, professionals, and agents of each thereof), from any and all Claims, obligations, rights, suits, damages, Causes of Action, remedies and liabilities whatsoever, whether liquidated or unliquidated, fixed or contingent, matured or unmatured, known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise

Finally, Article X(E) provided:

The Debtors, ... their members and Professionals (acting in such capacity) shall neither have nor incur any liability to any Person or Entity for any act taken or omitted to be taken in connection with or related to the formulation, preparation, dissemination, implementation, administration, Confirmation or Consummation of the Plan, the Disclosure Statement or any contract, instrument, release or other agreement or document created or entered into in connection with the Plan ... or any other act taken or omitted to be taken in connection



with the Chapter 11 Cases; provided, however, that the foregoing provisions of [this] Article X.E... shall have no effect on the liability of any Person or Entity that results from any such act or omission that is determined in a Final Order to have constituted gross negligence or willful misconduct.

[2][3] We have jurisdiction pursuant to 28 U.S.C. § 1291 because the District Court's approval of a professional's retention is a final order. We review the District Court's approval under § § 327(a) and 328(a) of the Bankruptcy Code for abuse of discretion, but review its legal determinations de novo. In re PWS Holding Corp., 228 F.3d 224, 235 (3d Cir.2000).

II. Standing and Mootness A. Standing

[4][5][6] While Houlihan Lokey couches its argument solely in terms of mootness, reading closely we find a separate component of its argument: standing. It contends that a suit against it "could only be brought by someone proximately harmed by Houlihan's negligence in performing these services, i.e., an actual or potential financial stakeholder of the UA Debtors." Appellee's Br. at 6. By virtue of the releases it obtained, it reasons, no such stakeholder can sue. Because the U.S. Trustee's appeal relies upon these potential claims, Houlihan Lokey therefore argues that the U.S. Trustee lacks standing. Houlihan Lokey also questions the U.S. Trustee's standing more obliquely, observing that "[i]ndeed, it is of more than passing interest that the party threatening to now disrupt this confirmed and effective plan is one with no such economic stake." Appellee's Br. at 12.

Contrary to Houlihan Lokey's claim, the U.S. Trustee "may raise and may appear and be heard on any issue in any case or proceeding." 11 U.S.C. § 307. A lack of pecuniary interest in the outcome of a bankruptcy proceeding does not deny the U.S. Trustee standing. See In re Columbia Gas Sys. Inc., 33 F.3d 294, 295-96 (3d Cir. 1994). U.S. Trustees are officers of the Department of Justice who protect the public interest by aiding bankruptcy judges in monitoring certain aspects of bankruptcy proceedings. Id.; accord In re Revco Drug Stores, Inc., 898 F.2d 498, 499-500 (6th Cir.1990). Thus, we find that the U.S. Trustee has standing to challenge the indemnification provision, [FN6] and turn to the issue of mootness.

FN6. We note that in *In re Metricom, Inc.*, 275 B.R. 364, 368 (Bankr.N.D.Cal.2002), Houlihan Lokey implicitly acknowledged the U.S. Trustee's standing to object by responding to its objections with proposed modifications.

*226 B. Mootness

[7] Houlihan Lokey argues that the case is both constitutionally and equitably moot. The first issue is a question of constitutional significance because, if a case is moot, we lack the power to hear it. Equitable mootness is a more limited inquiry into whether, though we have the power to hear a case, the equities weigh against upsetting a bankruptcy plan that has already been confirmed. We address each issue in turn.

1. Constitutional Mootness

[8][9][10] The United States Supreme Court sets a high threshold for judging a case moot. An appeal is moot in the constitutional sense only if events have taken place that make it "impossible for the court to grant any effectual relief whatever." Church of Scientology of Cal. v. United States, 506 U.S. 9, 12, 113 S.Ct. 447, 121 L.Ed.2d 313 (1992) (citation omitted). An appeal is not moot "merely because a court cannot restore the parties to the status quo ante [the state in which it was before]. Rather, when a court can fashion some form of meaningful relief, even if it only partially redresses the grievances of the prevailing party, the appeal is not moot." In re Continental Airlines, 91 F.3d 553, 558 (3d Cir.1996) (en banc) ("Continental I") (citations and quotation marks omitted).

[11] Houlihan Lokey asserts that this case is moot because Articles X(B), X(C), and X(E) of the confirmed Plan contain releases that preclude potential negligence claims against it. The U.S. Trustee counters that meaningful relief may still be obtained because the retention order may be vacated, at least as to the indemnification provision. With respect to Houlihan Lokey's Article X(C) argument, [FN7] that Article by its own terms subjects Houlihan Lokey to potential suits. Because Article X(C) releases the Debtors and their professionals from suits by "each Holder of a Claim who has accepted the Plan" (emphasis added), it does not bind all holders of claims. Rather, it covers only those who accept the Plan. Houlihan Lokey is correct that the "UA Plan was accepted by each impaired class that

was entitled to vote," Appellee's Br. at 8 n.2, but its point that each class is bound (regardless whether a member objected) misses the mark, even for those objecting who receive distributions under the Plan. If a class member accepts distributions because it is bound by the cram down provisions of § 1129(b)(1) of the Bankruptcy Code (i.e., a procedure for nonconsensual confirmation of a plan reorganization), but it has not itself accepted the Plan, Article X(C)'s release does not apply to it. Thirtyfour unsecured creditors voted to reject the Plan, and thus are unaffected by the release. Because by its own terms the release allows future claims, and in any event we can provide relief by modifying the retention order, Article X(C) does not render this case constitutionally moot.

FN7. We do not focus on Article X(B), which contains a mutual release of all claims among the Debtors, their affiliates, and the Releasees (defined to include "the D & O Releasees, the Prepetition Lender Releasees, the Placement Agent Releasees, Stonington, the Subordinated Note Releasees, and the Equity Releasees") because it does not affect all creditor constituencies.

[12][13][14] Next, Houlihan Lokey argues that Article X(E) of the Plan moots the U.S. Trustee's challenge because it excepts from liability (with a carveout for gross negligence and willful "[t]he Debtors ... and their ... misconduct) Professionals *227 (acting in such capacity) ... for any act taken or omitted to be taken in connection with or related to the formulation, preparation, dissemination, implementation, administration, Confirmation or Consummation of the Plan ... or ... the Chapter 11 Cases." It applies to Houlihan Lokey, albeit only when acting in a "professional" capacity. [FN8]

FN8. Thus Houlihan Lokey is not a "professional" when it is acting in its own interest, e.g., buying and selling claims.

Even on its own terms, Article X(E) contains carveouts (i.e., no forbearance from or tolerance of liability caused by willful misconduct or gross negligence). The question in the appeal comes full circle: can as a matter of public policy a professional be exempt from its own negligence. The answer

depends on how we treat nonconsensual releases of nondebtors.

Debtors and their professionals cannot exempt themselves from liability to non-consenting parties merely by saying the word. The "hallmarks of permissible non-consensual releases" are "fairness, necessity to the reorganization, and specific factual findings to support these conclusions." In re Continental Airlines, 203 F.3d 203, 214 (3d Cir.2000) ("Continental II"). Added to these requirements is that the releases "were given in exchange for fair consideration." Id. at 215. As in Continental II, here no finding in the confirmation order specifically addressed the releases at issue. [FN9] Id. Releases unbacked by adequate findings of fairness, necessity to reorganization and reasonable consideration cannot moot a challenge to the retention agreement's indemnity. What may not be valid (releases lacking the findings Continental II requires) ipso facto cannot moot an indemnity agreement whose order approving it was not final until after confirmation. [FN10]

FN9. The order confirming the Plan does provide, interestingly under "Conclusions of Law," that the "releases ... set forth in the Plan ... shall be, and hereby are, approved as fair, equitable, reasonable and in the best interests of the Debtors ... and their ... Creditors...."

FN10. It could be argued that in *In re PWS* Holding Corp., 228 F.3d 224, 246 (3d Cir.2000), we found an analogous release to be permissible under § 524(e). However, PWS's holding makes clear that it was not addressing a release that "affect[s] the liability of third [i.e., non- debtor] parties," id. at 247, and thus "is outside the scope of § 524(e)." *Id.* In discussing *Continental II*, the PWS panel noted that "[w]e did not treat § 524(e) as a per se rule barring any provision in a reorganization plan limiting the liability of third parties." Id. Rather, "it was clear under any rule that the court might adopt that the [third party] releases at issue were impermissible because 'the hallmarks of permissible non-consensual fairness, necessity to the reorganization, and specific factual findings to support these conclusions--are all absent here.' " (quoting Continental II, 203 F.3d at 214).



> More to the point, PWS did address the standard of liability for creditor committee members under § 1103(c) of the Bankruptcy Code, holding that this provision "limits liability of a committee to willful misconduct or ultra vires acts." PWS, 228 F.3d at 246. While it is unclear whether the Court meant to include professionals to committees as well (the very next sentence refers to "the entities that provided services to the Committee in the event that they were sued for their participation in the reorganization," id. at 246-47) and whether the rubric "ultra vires acts" is intended to cover any form of negligence, in no event does PWS cover more than immunity from liability under § The level of indemnity of 1103(c). professionals a debtor employs under § 327 is what is at issue in this case. Therefore, we cannot hold that the release moots an issue we have not yet examined.

While the merits of this appeal would have been singularly focused had the U.S. Trustee objected to the pertinent release provisions at confirmation, the bottom line is that the U.S. Trustee did object (and *228 strenuously) to the scope of the indemnity demanded by Houlihan Lokey. Potential claimants still exist. Reforming the indemnity provision would accord them meaningful relief. Therefore this case is not constitutionally moot.

2. Equitable Mootness

[15] We next examine equitable mootness. In this analysis, emphasis is decidedly on the first term of the phrase--whether the requested relief is equitable. "The use of the word 'mootness' as a shortcut for a court's decision that the fait accompli of a plan confirmation should preclude further judicial proceedings has led to unfortunate confusion." Continental I, 91 F.3d at 559. "[T]here is a big difference between inability to alter the outcome (real mootness) and unwillingness to alter the outcome ('equitable mootness'). Using one word for two different concepts breeds confusion." <u>Id.</u> (quoting <u>In</u> re UNR Indus., Inc., 20 F.3d 766, 769 (7th Cir.1994) (emphases in original)). Here we have the power to alter the outcome because the case is not constitutionally moot, but we must balance the equities of both positions and determine whether it is prudent to upset the Plan at this date. We consider five factors

in determining whether it would be equitable or prudential to reach the merits of a bankruptcy appeal ... [:](1) whether the reorganization plan has been substantially consummated, (2) whether a stay has been obtained, (3) whether the relief requested would affect the rights of parties not before the court, (4) whether the relief requested would affect the success of the plan, and (5) the public policy of affording finality to bankruptcy judgments.

Continental I, 91 F.3d at 560. In Continental I, we recognized that reversing a plan's confirmation might "knock the props out from under" "intricate and involved transactions," the consummation of which is relied on by the marketplace. <u>Id. at 561</u> (quoting <u>In re Roberts Farms, Inc.</u>, 652 F.2d 793, 797 (9th Cir.1981)).

In <u>In re PWS Holding Corp.</u>, we rejected an equitable mootness claim in a case involving, as already noted <u>supra</u> n. 10, a challenge to aspects of releases of liability of creditor committees and possibly their professionals. <u>228 F.3d 224, 236-37 (3d Cir.2000)</u>. There we observed that "[t]he plan has been substantially consummated, but ... [it] could go forward even if the releases were struck." <u>Id. at 236-37.</u> We therefore declined to dismiss on equitable mootness grounds.

[16] The relief the U.S. Trustee seeks here does not entail "knocking [out] the props" under the Plan. He only requests that the provision indemnifying Houlihan Lokey for negligent conduct be stricken from its retention agreement. If we were to modify the indemnity provision, the Plan otherwise would survive intact.

The remaining factors do not persuasively challenge this result. The fact that the U.S. Trustee did not obtain a stay weighs against it, but because the remedy it seeks does not undermine the Plan's foundation, this omission is not fatal. Moreover, allowing a challenge on public policy grounds to an indemnity provision is itself sound public policy. In this context, there is no equity in mooting the U.S. Trustee's challenge to the indemnity provision sought by Houlihan Lokey.

III. Permissibility of Debtors' Indemnifying Financial Advisors for Their Own Negligence

[17] Having concluded that the U.S. Trustee has standing to bring this appeal and that the issue is not moot, we turn to whether the indemnification provision was permissible. This is an issue of first

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impression *229 for this Court. [FN11] Section 328(a) of the Bankruptcy Code requires that the terms and conditions of employment of any professionals engaged under § 327 be "reasonable." 11 U.S.C. § 328(a). The question we therefore ask is whether it is reasonable for the Debtors to indemnify Houlihan Lokey despite its own negligence (but not gross negligence).

FN11. A bankruptcy appellate panel of the Eighth Circuit, <u>Unsecured Creditors'</u> Committee v. Pelofsky (In re Thermadyne Holdings Corp.), 283 B.R. 749 (8th Cir.B.A.P.2002), considered whether Houlihan Lokey, the financial advisor to a creditors' committee, could obtain indemnity for, inter alia, simple negligence. The B.A.P. held that it was not an abuse of discretion for the bankruptcy court to disapprove such expanded indemnity under the circumstances of thatcase.

Both parties make plausible points on the issue. The U.S. Trustee argues that allowing professionals to obtain indemnity for their own negligence encourages a standard both lax and "inconsistent with the financial advisor's fiduciary obligations to the creditors." Appellant's Br. at 24. Houlihan Lokey worries that the courts might "Monday-morning quarterback," or second-guess, decisions that in hindsight were clearly mistaken, but at the time seemed attractive options. Financial advisors would then be constrained and overly conservative in their advice, thus disadvantaging the estate.

[18] Though heretofore we have not addressed in depth the reasonableness of indemnifying financial advisors, we have recognized that § 330, which deals with what constitutes "reasonable" compensation for professionals, takes a "market-driven" approach. *In re Busy Beaver Bldg. Ctrs., Inc.* 19 F.3d 833, 852 (3d Cir.1994). While this case dealt with the reasonableness of paralegals' compensation, rather than their indemnification, it underscores that some reference to the market is not out of place when considering whether terms of retention are "reasonable" in the bankruptcy context.

Indemnification of financial advisors against their own negligent conduct is becoming a common market occurrence. *In re Joan and David Halpern Inc.*, 248 B.R. 43, 47 (Bankr.S.D.N.Y.2000), *aff'd*, No. 00-3601 JSM, 2000 WL 1800690 (S.D.N.Y.

Dec. 6, 2000). These provisions are of relatively recent origin, spurred by the In re Merry-Go-Round Enterprises, Inc. settlement of a suit against accountants advising the estate. 244 B.R. 327 (Bankr.D.Md.2000). Where previously there was no great concern with bankruptcy professionals being sued for negligence, after Merry-Go-Round professionals worried that suits would occur frequently, and they sought to lessen their potential liability by contracting for indemnification. See Joseph A. Guzinski, The United States Trustees: Ongoing Challenges, in 23rd Annual Current Developments in Bankruptcy and Reorganization 251, 274 (PLI Commercial Law and Practice Course, Handbook Series No. 820, 2001) ("In re Merry-Go-Round served as a kind of wake up call for bankruptcy specialists.... Fearing exposure to similar claims, specialists ... have sought indemnification by the company filing the bankruptcy."); Kurt F. Gwynne, Indemnification and Exculpation of Professional Persons in Bankruptcy Cases, 10 ABI L.Rev. 711, 727-29 (2002); Shanon D. Murray, U.S. Trustee Watchdog Starting to Bite, Some Say, N.Y.L.J., May 3, 2001, at 5 (stating that "the current movement of restructuring advisers who want to be indemnified for their bankruptcy work stems from a \$4 billion fraud, negligence and malpractice case that a regional trustee brought against Ernst & Young for its *230 role in the bankruptcy proceedings of Merry-Go-Round").

[19] However, that indemnification provisions like Houlihan Lokey's are now common in the marketplace does not automatically make them "reasonable" under § 328. [FN12] Our approach is "market driven," not "market- determined," especially in the realm of bankruptcy, where courts play a special supervisory role. With the understanding and limitations set out below, we believe Houlihan Lokey's indemnification agreement to be reasonable and therefore permissible under § 328. In coming to conclusion. we revisit traditional negligence/gross negligence analysis, borrowing from Delaware corporate law, and emphasizing that the indemnity provision leaves the door open to examining the level of care financial advisors exercise in the process of obtaining the results, rather than the results themselves. We look to Delaware corporate law as a guide primarily because it offers time-tested insights on how courts should best evaluate an issue similar to the one before us. [FN13] Additionally, Delaware's law often cues the market.

FN12. See, e.g., Unsecured Creditors

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Comm. v. Pelofsky (In re Thermadyne Holdings Corp.), 283 B.R. 749 (B.A.P. 8th Cir.2002); In re Metricom, Inc., 275 B.R. (Bankr.N.D.Cal.2002) (rejecting indemnification of Houlihan Lokey, advisor committee, bondholders' unreasonable where the debtor and official committee of unsecured trade creditors retained two other financial advisors without such indemnification agreements, and there was no showing that such an agreement was necessary). Cf. In re Comdisco, Inc., 2002 WL 31109431 (N.D.Ill. Sept.23, 2002) indemnity (reasonableness of professional advisors depends on the facts of each case); In re DEC International, Inc., 282 B.R. 423 (W.D.Wis.2002) (indemnity of bankruptcy professionals not per se unreasonable but must be scrutinized with care).

FN13. While the retention agreement between United Artists and Houlihan Lokey purports to be governed by New York law, our opinion relates to what is reasonable under § 328(a) of the Bankruptcy Code. As this without doubt is a matter of federal law, we need not examine New York law, and only refer to Delaware corporate law as a useful analogue.

[20][21][22] Directors and officers in Delaware may obtain indemnity for their own negligence. [FN14] Section 145(a) of Delaware General Corporation Law provides that corporations may indemnify directors and officers "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." 8Del.Code § 145(a). Section 145(b) requires that, if the director or officer is adjudged liable to the corporation, he or she will be indemnified "only to the extent that the ... court ... shall determine upon application that, *231 despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the ... court shall deem proper." Id. § 145(b).

FN14. Thoughdirectors and officers are fiduciaries of the corporations they serve, we do not hold financial advisors like Houlihan Lokey to be fiduciaries. Still, in

the bankruptcy context they may owe a higher level of care than in ordinary practice. Compare In re Gillett Holdings, 137 B.R. 452, 458 (Bankr.D.Colo.1991) ("Investment bankers and financial advisors hired by the Debtor are also fiduciaries."), and In re Allegheny Int'l, Inc., 100 B.R. 244, 246 (Bankr. W.D.Pa. 1989) ("We now hold that the investment bankers/financial advisors hired by the debtor and the Creditors' Committee are also fiduciaries."), with In re Joan and David Halpern Inc., 248 B.R. at 46 (earlier cases rejecting indemnification "overlook the common law permitting indemnity principles fiduciaries, and the idea that a fiduciary cannot be indemnified for negligence, or that such indemnification is contrary to public policy, is just plain wrong"), In re Mortgage & Realty Trust, 123 B.R. 626, 631 (Bankr.C.D.Cal.1991) (rejecting indemnification because it is inconsistent with "professionalism," but not holding financial advisors to be fiduciaries), and In re Drexel Burnham Lambert Group, 133 B.R. 13, 27 (Bankr.S.D.N.Y.1991) (same). The upshot for this case is that, to the extent that fiduciaries may obtain indemnity for their negligence, financial advisors in bankruptcy (who may or may not be fiduciaries) may do the same.

Changes in Delaware's corporate law make plain that § 145(b) requires the "adjudication of liability" to be one of gross, rather than ordinary, negligence.

Prior to the 1986 amendment to the statute, the language relating to the disqualifying adjudication read 'adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation.' Since Delaware case law has clearly established 'gross negligence' as the standard for liability of directors in violating their duty of care, the reference to 'negligence' in section 145(b) was inappropriate [and was therefore removed].

E. Norman Veasey et al., <u>Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42 Bus. Law. 399, 405 (1987); see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n. 31 (Del.1993); <u>Smith v. Van Gorkom, 488 A.2d 858, 873 (Del.1985)</u> (applying a gross negligence standard). In other words, the most that Delaware law requires of directors, though they are fiduciaries, is that they not be grossly negligent. 1 David A.</u>

Drexler et al., Delaware Corporation Law and Practice § 15.06[1], at 15-35 (2001) (citing Brehm v. Eisner, 746 A.2d 244, 262 (Del.2000), and Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984)). Put another way, Delaware courts tolerate ordinary negligence from corporate fiduciaries. It is important, however, to understand how these terms are understood in this particular context.

increasingly recognizing Courts are inherent in using the terms awkwardness "negligence" and "gross negligence" in the area of corporate governance. The art of governing (it is emphatically not a science) is replete with judgment calls and "bet the company" decisions that in retrospect may seem visionary or deranged, depending on the outcome. Corporate directors do not choose between reasonable (non-negligent) and unreasonable (negligent) alternatives, but rather face a range of options, each with its attendant mix of risk and reward. Too coarse a filter, the traditional negligence construct does not allow these nuances to emerge.

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading. Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency will rarely, if ever, be found liable for damages suffered by the corporation.

Joy v. North, 692 F.2d 880, 885 (2d Cir.1982) (Winter, J.) (citations omitted).

In simple terms, "[t]he vocabulary of negligence[,] while often employed ... [,] is not well-suited to judicial review of board attentiveness." In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959. 967 n. 16 (Del.Ch.1996) (Allen, C.) (citation omitted). The same principle applies to financial advisors. In situations where choices are not clear, neither are gradations of negligence as a means of analysis.

In the last two decades this confusion about what negligence means led to uncertainty about liability exposure for both corporate directors and financial advisors. A "crisis" in corporate governance arose when Delaware courts began to hold directors *232 personally liable for their negligence, and directors were unable to find insurance against the risks

associated with their jobs. See 1 Drexler, supra, § 15.06[1], at 15-36. As already noted, in the bankruptcy context the In re Merry-Go-Round settlement of a suit against an accounting firm advising the estate was a similarly seismic event for financial advisors. Houlihan Lokey and other financial advisors fear increases in liability exposure for the risks associated with doing their jobs. [FN15]

FN15. In this respect Houlihan Lokey's position is similar to that of creditor committee members. See 7 Lawrence P. King, Collier on Bankruptcy ¶ 1103.05[4], at 1103-32-33 (15th ed. rev.1996) ("If members of the committee can be sued by persons unhappy with the committee's performance during the case or unhappy with the outcome of the case, it will be extremely difficult to find members to serve on an official committee.").

[23][24][25] Delaware courts have resolved the negligence conundrum in the corporate sphere by evaluating the process by which boards reach decisions, rather than the final result of those decisions. A board's failure to inform itself of "all material information reasonably available" results in afinding of gross negligence. *Aronson*, 473 A.2d at 812. [FN16] In fact, Delaware's jurisprudence is a direct response to the type of concerns about second-guessing that Houlihan Lokey voices:

FN16. In <u>Merry-Go-Round</u>, claims regarding such a failure by the accounting firm were at issue.

[C]ompliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury [,] considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule--one that permitted an "objective" evaluation of the decision--would expose directors to substantive second

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guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests.

Caremark, 698 A.2d at 967 (emphases in original).

[26][27][28][29][30][31][32] When Houlihan Lokey agreed to advise the Debtors, it took on the role of a professional (indeed, one highly respected for its adept counsel in the high-stakes arena of major restructurings). Its job was to advise the Debtors well, and it owed them a duty of care in fulfilling this obligation. To disappoint the reasonable expectations of the Debtors, their creditors, and indeed the Court, is unacceptable. At the same time, Houlihan Lokey convincingly describes the stifling effects of unduly close scrutiny by the courts. A rule of reason must prevail.

Delaware has navigated the Scylla of condoning directors' misconduct and the Charybdis of stifling their business decisions with a rule that stresses not the end result, but the path taken to reach it. Under this approach, courts do not interfere with advice by financial advisors when they (1) have no personal interest, [FN17] (2) *233 have a reasonable awareness of available information after prudent consideration of alternative options, and (3) provide that advice in good faith. See 1 Drexler, supra, § 15.03, at 15-6. In the corporate sphere this is known as the "business judgment rule." A creature of common law, McMullin v. Beran, 765 A.2d 910, 916 (Del.2000), it acknowledges a judicial syllogism derived from five fundamental tenets:

FN17. The Bankruptcy Code itself requires that professionals working for the estate be disinterested persons, a term defined in 11 U.S.C. § 101(14). See also 11 U.S.C. § 327(a) ("[T]he trustee ... may employ ... persons[] that do not hold or represent an interest adverse to the estate, and that are disinterested persons"); id. § 328(c) (the court may deny compensation if during employment the professional "is not a disinterested person, or represents or holds an interest adverse to the interest of the estate"). While we leave for another day whether, for example, a financial advisor trading in claims with respect to a debtor it serves is disinterested, we note that such a circumstance is not rare.

(1) the management of a corporation's affairs is placed by law in the hands of its board of directors;

- (2) performance of the directors' management function consists of: (a) decision-making--i.e., the making of economic choices and the weighing of the potential of risk against the potential of reward, and (b) supervision of officers and employees--i.e., attentiveness to corporate affairs;
- (3) corporate directors are not guarantors of the financial success of their management efforts;
- (4) though not guarantors, directors as fiduciaries should be held legally accountable to the corporation and its stockholders when their performance falls short of meeting appropriate standards; and
- (5) such culpability occurs when directors breach their fiduciary duty--that is, when they profit improperly from their positions (i.e., breach the "duty of loyalty") or fail to supervise corporate affairs with the appropriate level of skill (i.e., breach the "duty of care").
- 1 Drexler, supra, § 15.03, at 15-6.

Here, where a debtor's financial affairs—the pith of a reorganization—are shaped by its financial advisors, they lay out the economic choices and assess their risks, and (though not sureties of success) can be held accountable for not advising with the level of care or loyalty expected, transposing the business judgment rule from its corporate ambit to bankruptcy appears well suited. For by this transposition we have a means to distinguish gross from simple negligence, and thus a benchmark for approving as reasonable an arrangement for indemnity that includes common negligence. [FN18]

FN18. Houlihan Lokey argues that our approach nonetheless subjects it to claims that it has not followed a correct process in advising debtors. While financial advisors are not Garibaldi for all reorganizations, they are trained to enhance their prospects. Undertaking this duty for so high a recompense (\$150,000 per month plus a "transaction fee" of 70 basis points of United Artists' debt) is hardly reasonable if that training is not applied.

Our understanding of the developing standards used in this area fortifies our view that the District Court did not abuse its discretion by finding the contested terms in the agreement at issue here to be reasonable. At this initial stage of the indemnity process (considering and approving a retention arrangement containing an agreement to indemnify for ordinary

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negligence), no evidence before the District Court tended to disqualify Houlihan Lokey under the tenets we set out for determining reasonableness of the indemnity proposed. [FN19]

FN19. Before the Court was the affidavit of Michael A. Kramer (Managing Director of Houlihan Lokey), submitted in support of the Debtors' application to retain Houlihan Lokey, and stating that it was "disinterested" (and thus had no personal interest in the *United Artists* cases), a claim that the U.S. Trustee did not dispute. There was no allegation that Houlihan Lokey imprudently considered financial options available tothe Debtors, nor was there any allegation of Houlihan Lokey's bad faith.

In any event, <u>section 328(a)</u> itself provides a safe harbor for the Court to reconsider its approval of any employment terms for professionals.

Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

*234 We reach this result with two caveats. The first is that Houlihan Lokey attempted to supplement its retention agreement with a provision in the retention application and approving order that in effect mandates indemnification to Houlihan Lokey for even its gross negligence if that negligence is not judicially determined to be "solely" the cause of its damages. In other words, the Debtors would be bound to indemnify Houlihan Lokey when its gross negligence contributed only in part to its damages. This attempted end run goes out of bounds for acceptable public policy. See Gwynne, supra, at 730-01 & nn. 106-07.

Secondly, as note 8 supra and the accompanying text indicate, Houlihan Lokey in the Plan sought indemnity only for actions in its professional capacity. The retention agreement arguably goes further, for it requires indemnification of Houlihan Lokey for contractual disputes with the Debtors. To the extent that Houlihan Lokey seeks indemnity for a contractual dispute in which the Debtors allege the

breach of Houlihan Lokey's contractual obligations, [FN20] this is hardly an indemnity-eligible activity. See Cochran v. Stifel Fin. Corp., No. Civ. A. 17350, 2000 WL 1847676, at *7 (Del.Ch. Dec.13, 2000), aff'd in relevant part, rev'd in part on other grounds, 809 A.2d 555 (Del.2002); cf. Gwynne, supra, at 731. [FN21]

FN20. We doubt that this kind of enhanced indemnity was contemplated by Houlihan Lokey. Subparagraph (a)(iv) of Exhibit A to the retention agreement speaks only of the breach by the Debtors of their contractual covenants, representations, and warranties. While subparagraph (a)(i) relates to any dispute involving the agreement (which theoretically may involve breaches by Houlihan Lokey of its obligations), it appears that such a conceivable argument is overridden by subparagraph (d), which exempts from indemnity "gross negligence, ... willful misfeasance, or reckless disregard [by Houlihan Lokey] of its obligations or duties" under the agreement.

FN21. As noted supra n. 4, the U.S. Trustee has not appealed whether the order permitting indemnification of Houlihan Lokey for its prepetition performance of services to the Debtors is reasonable under § 328(a). We therefore do not address this question.

Financial advisors are an essential part of reorganizations. Our decision today recognizes the need for safeguards from the second-guessing of creditors and, ultimately, the courts. At the same time, it assigns courts their accustomed task of evaluating the process by which advice is given. If financial advisors take the appropriate steps to arrive at a result, the substance of that result should not be questioned. So understood, agreements to indemnify financial advisors for their negligence are reasonable under § 328(a) of the Bankruptcy Code. [FN22]

FN22. Our concurring colleague has taken a more familiar path to the same result. That path is plausible and merits consideration. We go another way because the traditional

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approach sheds no light on when negligence becomes gross, and thus not indemnifiable. With great conviction, however, we disavow the attempt to blot our judicial escutcheon with the claim that we engage in "policy making" that "goes far beyond the parameters of our judicial function." We address directly the issue on appeal, see supra n. 4, and in deciding that issue explain when it is "reasonable" under S 328(a) of the Bankruptcy Code to approve an agreement to indemnify a financial advisor for its own negligence by laying down markers to discern what simple negligence is and is not. As our colleague points out, "the law is unsettled and our bankruptcy and district courts need guidance."

*235 IV. Conclusion

The U.S. Trustee has standing to bring this case. His claim is not constitutionally moot because Plan confirmation has not released all potential claims against Houlihan Lokey. It is not equitably moot because the relief requested will not upset the confirmed Plan. Because it is permissible for financial advisors to obtain indemnity for negligent acts if understood in the context noted above, the contested provision is acceptable. We therefore affirm.

ALITO, Circuit Judge, Concurring.

I fully join the thoughtful and scholarly opinion of the court but add a few words in response to Judge Rendell's concurring opinion. With respect, I believe that Judge Rendell's opinion quarrels with an opinion other than the one that the court has issued. The opinion of the court, as I understand it, holds only that the "reasonableness" standard of 11 U.S.C. § 328(a) does not categorically prohibit indemnification of financial advisers, as the United States Trustee argues. If such a blanket prohibition is desirable, it should be enacted by Congress.

Contrary to the suggestion in Judge Rendell's concurrence, the court does not hold that Houlihan Lokey's indemnification agreement must be interpreted in accordance with the principles of Delaware corporate law that the opinion of the court discusses. Nor does the court issue an authoritative interpretation of that agreement. Rather, the court

discusses principles of Delaware corporate law because they provide a sophisticated framework for evaluating the conduct of financial advisers and because this understanding of the circumstances in which in it sensible to hold financial advisers responsible for unsuccessful business decisions helps to explain why indemnification agreements such as the one in this case are not categorically "unreasonable."

RENDELL, Circuit Judge, Concurring.

I agree with the result reached by the District Court and agree that we should affirm its order. However, I respectfully reject the majority's ruling on the merits, as I read Judge Ambro's opinion, because it represents a significant departure, if not a quantum leap, from the issue before us.

Writing for the panel, brother Ambrodoes not address what the District Court did or the arguments raised by the parties on this unresolved yet important the opinion actually ignores the issue presented on appeal. The Trustee seeks a per se ban on provisions granting indemnity to financial advisors for negligence. Houlihan Lokey takes the position that such provisions should be permissible and that the court should examine them on a case-bycase basis. The parties briefed the various aspects of that issue, including the propriety of professionals' obtaining such indemnity and whether it was appropriate or necessary in the given setting. While, as the District Court noted, there is no binding caselaw, there are numerous cases that express differing views on the issue. [FN1]

> FN1. In rejecting a per se ban on indemnity provisions, the District Court focused on the "reasonableness" language in section 328(a) and conducted an independent analysis of this agreement. A number of other courts favor this approach and have used it to uphold some indemnity provisions and For example, the District reject others. Court for the Northern District of Illinois and the Bankruptcy Court for the Southern District of New York have both upheld similar indemnity provisions, rejecting the Trustee's argument that such provisions should be per se unreasonable. In re Comdisco, Inc., Nos. 02 C 1174 & 02 C 1397 (consolidated), 2002 WL 31109431, at

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*5, 2002 U.S. Dist. LEXIS 17994, at * 16 (N.D.III. Sept. 23, 2002); In re Joan & David Halpern, Inc., 248 B.R. 43, 47 Houlihan Lokey (Bankr.S.D.N.Y.2000). cites to numerous non precedential decisions of the Bankruptcy Courts for the District of Delaware doing the same. A'ee Br. at 22. Bankruptcy Courts in California and Colorado have also subjected indemnity provision to a full reasonableness inquiry. See, e.g., In re Metricom, Inc., 275 B.R. 364, 371 (Bankr.N.D.Cal.2002) (stating that "the issue is whether particular terms are reasonable under given circumstances, and such a determination can only be made on a case by case basis") (ultimately rejecting provision at issue); In re Gillett Holdings, 452, 4<u>58-59</u> B.R. 137 (Bankr.D.Colo.1991) ("This Court will not go so far as to hold that indemnity provisions per se are either unacceptable or circumstances. unnecessary in these Indemnity provisions must be analyzed on a case-by-case basis.") (citation omitted) (ultimately rejecting provision at issue); <u>In</u> re Mortgage & Realty Trust, 123 B.R. 626, 630 (Bankr.C.D.Cal.1991) (rejecting provision at issue because debtor had presented no evidence of its reasonableness). In support of her theory that indemnity provisions should be banned outright, the Trustee relies on an opinion from one of our own bankruptcy courts, In re Allegheny International, Inc., 100 B.R. 244, 247 (Bankr. W.D.Pa.1989). In Allegheny, Judge Cosetti decided that financial advisors were fiduciaries of the debtors who hired them. Id. at 246. He went on to appropriate Judge Cardozo's famous remarks in Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, 546 (1928), for the proposition that fiduciaries owe the highest standard of care, and to conclude that "holding a fiduciary harmless for its own negligence is shockingly inconsistent with the strict standard of conduct for fiduciaries." Allegheny, 100 B.R. at 247. Courts faced with this issue have referenced the "fiduciary" language, but have generally looked at an advisor's fiduciary status as one factor in a reasonableness analysis, not as support for a per se ban on indemnity. See, e.g., Gillett, 137 B.R. at 458; Mortgage & Realty Trust, 123 B.R. at 630. Here, the parties have not argued that

professionals like Houlihan are fiduciaries as such, and I suggest that resort to nomenclature for resolution of the issues before us would be wrong. The issue here is "reasonableness" under section 328(a). An agreement about what status might be attributed to professionals based on analogous corporate trust principles should give way to a consideration of what is reasonable under all of the circumstances in the bankruptcy context.

*236 Instead of addressing these arguments, Judge Ambro's opinion ventures into the arena of corporate law and fashions an open-ended good faith business judgment rule, based upon Delaware corporate law principles, as the test for the "reasonableness" of advisors' indemnity. It does so because it finds the concepts of negligence and gross negligence to be too results-oriented.

I do not doubt that scholars and professors--and indeed some practitioners-- may have an aversion to distinctions made between negligence and gross negligence and have therefore suggested that corporate directors should not be liable if they follow the appropriate process and exercise their business judgment. However, that is not the issue before us, nor is it a concept that either of the parties has even remotely embraced.

Responding to a line of inquiry at oral argument, the Trustee and Houlihan Lokey filed supplemental briefs specifically addressing the propriety of our creating a new "reasonableness" standard separate and apart from the negligence principles embodied in their agreement. They specifically*237 requested that we not do so. [FN2] As both parties have noted, we should decide the issue presented to us, not craft new rules or address matters beyond the scope of the appeal. I should note that I would favor Judge Alito's reading of Judge Ambro's opinion, but fear it will not be so read.

FN2. In their Supplemental Briefs, the Trustee and Houlihan Lokey both pointed out the dangers inherent in our creating a new standard in this case. First and foremost, both parties noted that our appellate jurisdiction should be limited to deciding the issue presented, that is, whether the District Court abused its discretion in approving the retention agreement. See

App. Supp. Br. at 3 ("The crafting of new negligence standards ... seems inconsistent with the scope of this appeal.")

The parties also implored us not to venture into the realm of the legislature, as we are not equipped to weigh the many complicated that go into bankruptcy interests administration, nor can we predict the implications of a new untested standard or the ways it might upset the current balance of incentives. App. Supp. Br. at 6-7; A'ee Supp. Br. at 6. The Trustee worries that the majority's test will essentially excuse all professional misconduct by financial advisors, while for its part, Houlihan Lokey fears the rigid test will undermine its own safeguards, exposing it to "process" litigation by creditors unhappy with their recovery, even where there was no basis on which to attack the substantive advice actually given. App. Supp. Br. at 9; A'ee Supp. Br. at 5. In short, neither party revealed any inclination to support what the majority has done. Rather, both vehemently argued against this approach.

I cannot help but wonder why we should resort to reasoning that "eschews the inherent imprecision between shades of negligence" when the parties bargained under traditional negligence principles and rules. And why should we concern ourselves with Delaware law applicable to directors, when the retention agreement here was specifically governed by New York law and was meant to govern a relationship not with directors, but between a company and its professional financial advisors? [FN3] Financial advisors are not directors, and I do not find their status to be analogous.

FN3. Although United Artists is a Delaware corporation, its retention agreement with Houlihan Lokey contains an explicit choice of law provision specifying New York law as the governing state law. App. at 132-33.

I must confess that although I would acknowledge that my colleagues sincerely believe that their view represents a contribution to our thinking about the issue at hand, I find it very difficult to conceive of the application, and implications, of this new test. Presumably, the first and third prongs-"disinterested" and "good faith"--are easily met, but

what does the second prong mean? When does a financial advisor *not* have "a reasonable awareness of available information after prudent consideration of alternative options"?

In a footnote, Judge Ambro seemingly applies the post-hoc test he espouses (n.19), concluding that the evidence before the District Court revealed no personal interest on the part of Houlihan Lokey in the United Artists cases, and that, because there were no allegations of imprudent consideration by Houlihan Lokey of the available financial options or of bad faith, Houlihan Lokey is entitled to indemnity. Even were I to agree that the creation of a new test is warranted, surely this is not the way to apply it. This conclusory treatment leaves us uncertain as to how the test should be applied in other instances. I cannot tell whether it will provide a blank check for substandard performance (as the Trustee urges), or will foment process-oriented litigation (as Houlihan Lokey submits). Further, I cannot imagine what guidance we are giving to the District Court by changing the rules midstream, *238 much less what implications this poses for indemnity agreements already in force.

The rationale for adopting this test--namely, an aversion to a "results- oriented" approach to liability, and therefore, indemnity-goes far beyond the parameters of our judicial function, into the sphere of policy making. To my mind, the adoption of a business judgment rule as providing a standard for indemnification of professional advisors is fraught with policy considerations, none of which has been explored in this case. These are the types of concerns that should be considered in the first instance by a legislative, rather than a judicial, body. Further, the test can only be applied after the fact, thus essentially emasculating the bankruptcy courts' testing of terms of retention at the time of retention, as is clearly envisioned by section 328(a). I fear that our grafting such a test onto section 328(a) goes beyond our ken, especially here where we are reviewing a determination by the District Court that followed traditional lines of reasoning.

The issue actually before us, as framed by the parties and decided by the District Court, deserves our attention. Is there something essentially problematic with the concept of professionals bargaining for indemnity against their own negligence? Should it ever be permitted? If so, under what circumstances? We should address the issue as presented, because the law is unsettled and our bankruptcy and district courts need guidance.

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The District Court considered the merits of this issue very seriously and thoroughly, entertaining briefing and oral argument that spans nearly 500 pages of the voluminous appendix submitted on appeal. Instead of creating a new test, I would affirm by disavowing the notion of a per se ban, engaging in a discussion of the factors that the courts have examined in considering "reasonableness" on a case by case basis under section 328, and approving the ultimate result reached by the District Court based on the extensive record presented. [FN4]

FN4. Among the specified factors, and facts, weighing in favor of the reasonableness of this agreement in the situation presented here are: 1) the retention of Houlihan Lokey was in the best interest of the estate, as it played a crucial role in the restructuring; 2) United Artists' creditors approved the agreement and have never objected to the indemnity provision; 3) the agreement did not provide blanket immunity, but rather contained detailed procedures determining at a later date whether a particular application for indemnity should be granted; 4) Houlihan Lokey had been retained pre-petition under an agreement containing an indemnity clause. Most of its work was performed prior to the initiation of bankruptcy proceedings, so, relatively speaking, its post-bankruptcy indemnity was not particularly significant; 5) United Houlihan Lokey Artists and sophisticated business entities with equal bargaining power who engaged in an arms length negotiation; 6) such terms are viewed as normal business terms in the marketplace, see In re Busy Beaver Bldg. Centers, 19 F.3d 833, 849 (3d Cir.1994) (condoning a "market-driven" approach to reasonableness); and finally, 7) under the terms of section 328, the District Court retained discretion to modify the agreement "if such terms and conditions prove to have been improvident." 11 U.S.C. § 328(a). Indeed, we have encouraged similar exercises of discretion in the realm of postbankruptcy fees for attorney services to debtors under 11 U.S.C. § 330. In re Top Grade Sausage, Inc., 227 F.3d 123, 132-33 (3d Cir.2000). I would therefore approve the indemnity agreement, subject to the two caveats noted by the majority, as discussed in the penultimate paragraph of this concurrence.

The review and assessment of the law and the record--rather than the creation of a slippery slope for testing consulting professionals' liability in the bankruptcy arena--should be the basis of our rule. The concluding paragraphs of the opinion *239 seem to venture into an analysis of "reasonableness," noting two aspects of the indemnity agreement that are, respectively, an "end run" around "acceptable public policy" (the indemnity for gross negligence when that negligence is not solely the cause of damages), and not an "indemnity- eligible activity" (the indemnity for contractual disputes with Debtors). These aspects were never argued or briefed, but I suggest that it is this type of scrutiny of the provisions of the retention agreement that is called for under the "reasonableness" standard of section I agree that, assessed under the 328(a). "reasonableness" standard, these two terms do not pass muster. But, unfortunately, we are left confused as to whether the overall inquiry is, as urged in the thrust of the opinion, a post hoc examination, or whether some scrutiny--on some reasonableness basis--is to be undertaken at the outset. It is hard to imagine that reasoning done at the outset, if it does occur, could be anything other than a complete and binding determination of "reasonableness," making some after the fact business judgment rule unnecessary and uncalled for. Once again, we are left questioning how to apply this test.

Therefore, although I concur in the resulting affirmance, I would arrive at that result via an entirely different route.

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